R4105-69-F(A) 11/88

The Conference Board

The Audit Committee: A Broader Mandate

- *more responsibility, more authority*
- *more impact in improving financial controls-reporting*
- *growing role in strengthening auditors' independence*
- *major force in boosting board effectiveness*

Research Report No. 914

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Conference Board Report No. 914

Printed in U.S.A.

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ISBN NO.: 0-8237-0358-4

The Audit Committee: A Broader Mandate

by Jeremy Bacon

A Research Report from The Conference Board

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From The President

The audit committee stands out in bold relief as a success story among the array of organizational approaches to making corporate boards of directors more effective. It is the triumph of an old concept whose virtues have been rediscovered and put into practice on a very broad scale.

The acceptance of this board committee was already impressive in 1978, when The Conference Board conducted research on it (the resulting report was published the following year). By then audit committees had recently been made a mandatory condition of listing on the New York Stock Exchange, but they were in place in most major firms anyway. And all the key players in the audit process—financial management, chief executives, boards of directors, and both outside and inside auditors—were not only comfortable with the committee but depended on it.

Why, then, a new report? One purpose was to find out how the past decade of widespread use has affected, if at all, the role delegated to this committee, and to assess the committee's impact over this period. Another reason is that several events during those intervening years have put more focus than ever on this watchdog committee. Corporate failures or near-failures have occurred for which little or no warning was given by financial statements of the firms involved. Charges of inaccurate, misleading or fraudulent corporate reporting have been persistent, causing concern not only in the Securities and Exchange Commission but in Congress and the private sector as well.

This report spells out how these and other changes have affected the functioning of audit committees. Beyond presenting new findings, the study updates much of the data in the original edition. It also includes a large selection of committee charters and other illustrative material.

Like all Conference Board research, this project is aimed primarily at informing and guiding those who have a direct, decision-making responsibility. In this case, that group includes chief executives, who not only work with their own audit committees but frequently also serve as outside members of other audit committees. The report will also interest government policymakers and others concerned with the audit committee's importance in corporate oversight.

We would like to thank both the American Society of Corporate Secretaries for its permission to survey its members and the individual members who completed a questionnaire. We also acknowledge gratefully the cooperation of 121 chief executives and chief financial officers of major corporations who responded to a separate survey, as well as the time and information shared by audit committee chairmen and members in interviews.

PRESTON TOWNLEY
President

Highlights

Since 1978, several developments have focused attention on audit committees and exerted pressure for change, including:

- Corporate failures;
- Takeovers and other business combinations;
- The growing role of internal auditing;
- A crisis of confidence in public accounting;
- A major research project and report by the National Commission on Fraudulent Financial Reporting (Treadway Commission), a private-sector initiative; and
- Regulatory and legislative initiatives.

Responses from 629 corporations to a questionnaire on the composition and function of the audit committee indicate the following changes since 1978:

Audit committees have become more involved with internal auditing. The internal auditors of 47 percent of the companies in the current survey have some kind of reporting relationship to the audit committee or its chairman; only one-fourth of the 1978 respondents reported such a relationship.

The internal auditor has jumped into second place behind the corporate secretary as the person most often designated as secretary of the audit committee.

The committee chairman is still the person most often involved in determining audit committee agendas, followed by the chief financial officer. But the head of internal auditing is now a close third, a significant gain from the 1978 survey.

There is also more emphasis on the committee's role in supporting and ensuring the independent status of the *outside* auditors: Eight-five percent meet with the auditors without management being present at least once a year; 60 percent have at least *two* such private sessions.

Thirty-seven percent (compared to only 15 percent in 1978) of surveyed companies have a procedure for approving *in advance* any services to be performed for the company by the outside auditors that are not part of the audit process.

Eight percent of firms had changed their auditing firms during the past three years. The reasons mentioned most often were: to obtain better service or upgrade to a major accounting firm, and to reduce fees.

Today's committees also look somewhat different. Compared to 1978:

- Audit committees are larger: median sizes are now four members for manufacturing and nonfinancial services companies—up from 3 in 1978—and 4.5 for financial firms, up from four.
- Their members include fewer directors with relationships that might interfere with the exercise of independent judgment, especially former executives of the company and directors affiliated with banks serving the company. Ninety percent of the committees have *no* members with such a potential conflict of interest.

The median reporting frequency is three times a year, up from twice a year in 1978.

Ninety-two percent of committees now conduct their meetings according to a written agenda prepared in advance. This represents a substantial increase over the 1978 survey, especially for nonfinancial companies. Some committees set meetings agendas a year or more in advance.

Comments by 121 chief executives and chief financial officers based on their experience with audit committees show that:

Audit committees have been delegated increasingly broader responsibilities. Thirty-seven percent of the CEOs/CFOs surveyed favor the trend toward an expanded role; another 39 percent think it is appropriate for many companies (but not all). The remaining 24 percent feel that a broadened role for the committee should be limited to situations where special oversight is needed.

Three-fourths of these respondents are concerned that the added responsibilities being placed on audit committees will increase the risk of committee members being sued. But most believe that indemnification, insurance and state statutory protection, as they are evolving, will offset additional exposure.

Respondents also gave the audit committee high marks for having brought about improvements in other traditional core areas of their role—external audit, internal auditing,

financial controls, and financial reporting. Many agreed that the committee's work has also improved both the full board's awareness and understanding of these matters and also its effectiveness.

The internal audit function, in particular, has benefitted from its growing relationship with audit committees, according to a large majority of the surveyed chief executives and chief financial officers. Almost 90 percent say the committee's involvement has improved internal auditing *procedures* or *practices*; just over 80 percent say the *effectiveness* of internal auditing has been improved.

Sixty-four percent of the chief executives and chief financial officers surveyed believe that serving on an audit committee takes more time now than ten years ago. Seventy-four percent said that service will probably take even more time in the future.

Study Methodology

A questionnaire requesting information about the composition and function of corporate audit committees was sent in October 1987, to members of the American Society of Corporate Secretaries. Data from the 692 responses were used to update tables from the prior 1978 survey and to provide comparisons between the two survey years (there were 628 respondents to the 1978 survey). The current survey also supplied material for new tables.

More than half of the respondents to the 1987 survey also supplied documents—over 350—spelling out the duties and responsibilities of their firms' audit committees. This rich store of information was extremely valuable in the preparation of the report.

As the following tables demonstrate, the 1987 participants represent a broad cross-section of industries and company size.

Survey Sample, by Type of Industry

	No. of Companies
Manufacturing	270
Financial:	
Banking	96
Insurance	50
Other	32
Total financial	178
Nonfinancial service:	
Utility	90
Merchandising	29
Diversified services	19
Communications	18
Transportations	14
Other	74
Total nonfinancial service	244
TOTAL	692

Survey Sample, by Size of Company

Company Size by Sales (assets for financial companies)	*Manufacturing*	*Financial*	*Nonfinancial Service*	*Total*
Under $100 million	19	4	28	51
$100 – 199	14	10	17	41
$200 – 499	39	16	45	100
$500 – 999	48	19	41	108
$1-3 billion	64	34	48	146
Over $3 billion	65	83	41	189
				635

A separate, shorter questionnaire was sent in January of 1988 to a list of chief executives and chief financial officers of major firms. This questionnaire sought their opinions on a number of issues, including serving on audit committees; various proposals concerning the committee's role; the effectiveness of such bodies; and prospects for change. A total of 121 executives—56 CEOs and 65 CFOs—shared their views on these issues, adding their judgment and experience to the report's statistical findings. Personal interviews with chairmen and committee members provided further clarification and insight.

Chapter 1
A Decade of Challenge and Change

The year 1978 was a landmark year for audit committees. By that time, they outnumbered all other board committees, especially in major firms. The New York Stock Exchange had taken the pioneering step of requiring every listed company to have an audit committee composed entirely of outside directors. And, as important, there was strong support from top management and directors for a strongly independent audit committee that could be an effective financial watchdog. A Conference Board study published in 1979 quantified and described these developments.[1]

Research conducted in 1987 and 1988 indicates that, to an impressive extent, the audit committee has moved even further in the direction of acceptance, independence, and authority. The evidence of this trend can be found throughout this new report, which updates much of the data in the earlier one and also adds new information.

Oddly enough, in the decade spanning the two reports, the broad movement to strengthen corporate governance abated somewhat. All of the concerned parties were distracted by: the decline in some key U.S. industries and their inability to compete; corporate failures (partly attributed to mismanagement); a surge in takeovers and other corporate restructurings; and a crisis in liability insurance coverage for executives and board members just when it was most needed. In addition, the emphasis on strengthening the oversight performance of boards of directors, long prominent on the Security and Exchange Commission's agenda, was not continued under the Commission's present leadership (although corporate disclosure remains a high priority).

Factors Promoting Change

Given the diminished interest in corporate governance in general, why has the audit committee attracted more and more attention—and, in many companies, shouldered more responsibility?

Corporate failures: Some of the country's best-known corporate names have gone into bankruptcy or ceased to exist in recent years. Bad judgment, or mismanagement, is an often-cited factor; inadequate financial controls and reporting systems share the blame. In the banking and thrift industries, in particular, where failures and bail-outs have reached unprecedented levels, the effectiveness of audit committees has been questioned in some cases, and severely tested in general.

Takeovers and other business combinations: Mergers and acquisitions, especially the unfriendly kind, have generated substantial litigation. At the heart of many of these lawsuits is the charge that a company issued false or misleading information about its financial circumstances. Such allegations also call the audit committee's role into question and increase the burden on the audit committees of newly merged operations to oversee the development of proper auditing, accounting and reporting procedures. Many audit committees have faced this situation in the past ten years.

The growing role of internal auditing: Once a kind of stepchild function in many companies (and not even found in many others), internal auditing has steadily gained in status and influence in the corporate organization over the last decade. Audit committees have been a factor in that progress, some of which stems from the Security and Exchange Commission's ongoing campaign to improve the reliability and quality of corporate financial reporting and controls. One of the findings of this report is a strengthened relationship between the internal auditing function and the audit committee.[2]

An "expectation gap" regarding independent audits: In recent years there has been controversy over how much weight should be given to the fact that a company's financial statements have been audited by an independent accounting firm. Some investors want to hold outside accountants legally responsible for financial statements they have audited: others go further and take the view that the annual audit should produce, in effect, a clean bill of financial health for the com-

[1] Jeremy Bacon, *Corporate Directorship Practices: The Audit Committee*, The Conference Board, Report No. 766, 1979.

[2] The internal auditing function is the subject of a Conference Board report due for publication a few months after this one. It will be a complete revision of a study first published in 1978.

pany. The accounting profession argues that these are unreal expectations and that the customary audit process lacks the thoroughness that would be necessary to meet them.

The controversy persists, however, and one of the ways in which accounting firms have responded to it is by promoting the role of the audit committee. Many accounting firms now publish material to help audit committee members understand the audit process and strengthen their monitoring abilities.

Early in 1988 the American Institute of Certified Public Accountants' Auditing Standards Board approved a new Statement on Auditing Standards (SAS No. 61, *Communications with Audit Committees)* that requires auditing firms to convey specified information to the audit committee of a client firm. The list of required items of disclosure includes: any significant audit adjustments made; any major disagreements or difficulties encountered with management; and the auditor's opinion on any matter of importance raised between the client company and any other auditing firm.

The Treadway Commission: What may turn out to be the most influential private-sector initiative, however, is the National Commission on Fraudulent Financial Reporting, a panel of six prominent leaders from the business and financial worlds, including James C. Treadway, Jr., a securities industry executive and former SEC commissioner, who served as chairman, and for whom the Commission was nicknamed. It was sponsored and funded by the American Institute of Certified Public Accountants, the American Accounting Association, the Financial Executives Institute, the Institute of Internal Auditors, and the National Association of Accountants.

Beginning in 1985, the Commission spent two years taking a thorough look at corporate financial reporting and controls procedures, with the goal of minimizing the incidence of fraudulent and misleading corporate disclosures. The Commission's information-gathering process involved more than 20 internal research projects, studies by outside experts, and extensive interviews with and commentaries by other interested parties.

The Commission's final report, published in October 1987, contains many recommendations addressed to corporations, independent public accountants, the SEC and other regulators, and educators. Many of these recommendations specifically involve the audit committee. In addition, the report includes "Good Practice Guidelines for the Audit Committee." The report states: "To companies that already have audit committees, the guidelines will serve as a standard for review and assessment. Other companies—those just establishing audit committees or those seeking to improve their committees' effectiveness—may find them to be helpful in suggesting practical ways for audit committees to discharge their responsibilities." A copy of these guidelines is included in this report; see Appendix A.

For the most part, there is public support for the Treadway Commission's goal of increasing the reliability of financial reporting and for its specific recommendations and guidelines for audit committees. These are not revolutionary; almost all are already practiced by at least some committees. (An earlier draft did elicit some strong objections. An example is the recommendation that the audit committee *approve* quarterly financial statements; the final recommendation called only for the committee to "oversee the quarterly reporting process.")

Many companies are expected to use the Commission's recommendations as a benchmark and quite a few audit committees have already explored how their own practices measure up. Because many major companies already conform to much of what the report deems good practice, their audit committees are unlikely to undergo sweeping changes. On the other hand, a number of executives involved in revising the charters of their firms' audit committees, or planning to do so, report that they are taking the Treadway Commission recommendations into consideration.

The Board surveyed chief executives and chief financial officers for their views on some of the specific proposals or opinions related to audit committees that were included in the Treadway report. Their responses are shown in Table 1.

Three of the six items in the table are clearly viewed as appropriate for audit committees by a majority of the 121 executives. For example, two-thirds of the respondents believe it is appropriate for the committee to review the appointment and the dismissal of the company's chief internal auditor. In practice, some committee charters take this a step further, requiring that the committee actually approve the choice for this position; some committees also review proposed salaries for the post. Involving the audit committee in these decisions—which brings the committee close to the critical line between oversight and making management decisions—is intended to prevent management from using its hiring or compensation powers to influence the independence of the chief internal auditor. The extent to which CEOs and CFOs are comfortable with granting such authority to the audit committee is indicative of the importance they attach to the independent status of the internal auditor.

Sixty-three percent of the CEOs and CFOs found it appropriate for the audit committee to "monitor and evaluate compliance with the company's code of ethical conduct," which, in fact, assigns a stronger role to the audit committee than the Treadway report. (The report's recommended role for the audit committee relative to codes of conduct is to review annually how *management* is monitoring the code.) It is significant that so many executives favor a monitoring role for the audit committee regarding compliance with such codes, given that some observers feel this draws the committee into an area of responsibility outside its traditional financial concerns. The Commission's view on this was clear; a code of conduct is a necessary and integral part of a company's procedures for preventing fraudulent reporting, and a proper matter for oversight by the audit committee.

The Treadway Commission's good practice guidelines include a lengthy list of what an audit committee should do or consider doing. Nearly 60 percent of the survey respon-

Table 1: Reactions of 121 Chief Executives and Chief Financial Officers to Selected Treadway Recommendations

Treadway Commission Recommendation or Concept	*Percent of Respondents that Find the Recommendation or Concept to Be: Appropriate*	*Open to Question*	*Inappropriate*
The audit committee should review the appointment and the dismissal of the chief internal auditor.	67%	18%	16%
The audit committee should monitor and evaluate compliance with the company's code of ethical conduct.	63	23	13
The Commission proposes "good practice guidelines" that audit committees should be expected to follow or strive for.	58	40	2
The Commission suggests that adherence to its proposed guidelines could serve as evidence of diligence for legal purposes.	32	53	14
The audit committee should oversee the quarterly financial reporting process (but not approve the reports).	28	30	42
The company's annual report should include a report from the audit committee chairman on the committee's activities.	18	40	42

Due to rounding, not every row equals 100 percent.

dents favored such guidelines but a sizable minority, 40 percent, found them open to question. For the most part, the guidelines reflect what many committees already practice; individually, at least, they are not novel or burdensome additions. But there has always been resistance to the idea of mandated or prescribed rules for the membership, organization, or practices of boards of directors. The guidelines may seem to some observers as a step toward dictated practice, even though the Treadway Commission has no powers to enforce its recommendations. Others apparently fear that, to the degree the guidelines become the norm for audit committees, failure to follow all of the "good practices" might be considered a lack of diligence.

The fourth Commission proposal in Table 1 addresses the liability concern issue. The Commission expressed the hope that its guidelines would have a *positive* effect where liability is concerned:

> "The Commission is aware of current difficulties in recruiting directors because of director liability and inadequate or unavailable insurance coverage. The Commission hopes that its recommendations, particularly those calling for an effective, independent audit committee, will ameliorate these concerns. The formal charter of the audit committee clarifies its duties and responsibilities, and the guidelines ... can assist audit committee members in meeting these responsibilities. Both can be helpful in the event of litigation and may

offer insurers the degree of comfort they need to issue more favorable insurance coverage to directors."[3]

Note that only about a third of the respondents feel that the Commission's reassurances are well-founded.

The items in the table that drew the highest number of "inappropriate" responses (42 percent in both cases) are (1) a recommendation that the audit committee oversee the quarterly financial reporting process and (2) a recommendation that the annual report include a statement from the chairman of the committee. Objections to the latter are based largely on a conviction that a committee chairman's report would add nothing useful to the annual report or to the disclosure process. Critics of having the committee oversee the quarterly (unaudited) reporting process feel that this role would increase the committee members' exposure to liability; there is a discussion of this point in Chapter 5.

Other private-sector initiatives: In 1987, the Institute of Internal Auditors (IIA) published a report in favor of audit committees—for public companies as well as not-for-profit and government organizations. Titled *Internal Auditing and the Audit Committee: Working Together Toward Common Goals,* this publication includes the Institute's formal position on audit committees along with summary statements concerning the membership and function of the audit committee, including the importance of cooperation between such committees and the internal auditing function. Among other things, the Institute recommends that internal auditing report to the committee, that the committee review and approve the charter under which the internal auditing function operates, and that committee approval be required for appointing or dismissing the company's director of internal auditing. These recommendations are included among the proposals made by the Treadway Commission.

Another organization that has given the audit committee priority on its agenda is the American Law Institute (ALI), a prestigious group of lawyers and judges. The ALI has worked since 1980 to develop a policy statement covering many aspects of corporate governance, including boards of directors. Historically, ALI pronouncements ("restatements") on points of law have had significant influence on the courts; some observers believe that an ALI statement on corporate governance would also influence practice. Included in a draft version of the ALI statement is the requirement that all major companies have an audit committee of independent directors. In addition, the draft calls for the committee to be entrusted with specified powers and functions and argues that it is acceptable to assign the committee responsibilities that go beyond its traditional role. The inclusion of the audit committee by the ALI draftsmen attests to the organization's faith in this body as an instrument of board oversight.

Regulatory and legislative initiatives: Over the past decade the Securities and Exchange Commission has pushed for more accurate and substantive corporate disclosure. One example is a new rule that companies must inform the SEC when they change their outside auditing firm, specifying whether the firm resigned or was dismissed by the company, whether disagreements, if any, between management and the former auditors were discussed with the board of directors, and whether management hindered communications between the old firm and the new. Management must also disclose what accounting rules or issues it discussed with its new auditors prior to engaging them. The rule is aimed at preventing companies from "opinion shopping," or finding auditors who will support management's interpretation of particular accounting rules or issues.

No federal legislation has yet been passed that directly requires or affects audit committees, although bills with such features have been proposed. However, in 1987 an SEC-approved rule requiring audit committees was adopted by NASDAQ for companies traded on its National Market System. A box in the next chapter contains more information about this development.[4]

[3] *Report of the National Commission on Fraudulent Financial Reporting*, 1987, p. 42.

[4] As noted in the 1978 report, the Foreign Corrupt Practices Act (1977) involved audit committees indirectly, by requiring companies to have effective internal controls systems; a few of the committee charters for this report submitted by respondents refer specifically to the responsibility of the committee for reviewing compliance with this statute. The Oversight and Investigations Subcommittee of the House Energy and Commerce Committee is considering a legislative package aimed at improving auditing and financial reporting. The Subcommittee's chairman, Representative John D. Dingell (D-Michigan), has been pressing the SEC to implement some of the Treadway Commission's proposals. Chairman Dingell believes it would be appropriate to require by law that all public companies have independent audit committees.

Chapter 2

The Composition of Today's Committees

The makeup of audit committees has changed in some respects over the past decade, and rotation of membership is more prevalent. The changes strengthen the committee's independent status.

Committee Size

The current survey indicates that audit committees have increased in size. Table 2 shows that the median number of members is now higher in all three industry categories than in 1978. Financial firms reported the largest audit committees, with a median membership of 4.5, up from four in 1978.

As in the past, the larger the company, the larger its audit committee is apt to be. Table 3 shows this relationship; the median company in the smallest size category (under $100 million) has a three-member committee; the median committee size in the $3-billion category is five. For the most part, the medians relative to company size have not changed from the 1978 survey.

Affiliation or Background of Members

Table 4 shows the business or professional affiliations of the almost 3,000 directors serving on the 692 audit committees analyzed in this report. Most categories show little change between the 1978 and the 1988 surveys. Active chief executives of manufacturing companies or service companies (other than financial firms) are still the most common

Table 2: Committee Size, by Industry Category, 692 Companies

	Number and Percent of Committees in Each Industry Category					
	Manufacturing		*Financial*		*Nonfinancial Service*	
Number of Members	*Number of Committees*	*Percent*	*Number of Committees*	*Percent*	*Number of Committees*	*Percent*
1	1	–	1	1%	–	–
2	10	4%	1	1	21	9%
3	92	34	41	23	79	32
4	76	28	45	25	63	26
5	56	21	43	24	41	17
6	28	10	23	13	24	10
7	5	2	15	8	11	5
8	2	1	6	3	3	1
9	–	–	3	2	1	–
11	–	–	–	–	1	–
Totals	270	100%	178	100%	244	100%
Median committee size	4		4.5		4	
Modal committee size	3		4		3	
1978 medians	3		4		3	

Table 3: Committee Size, by Size of Company, 691 Companies

Number of Members	Number of Committees in Each Company Size Category[1]					
	Under $100 million	*$100-199 million*	*$200-499 million*	*$500-999 million*	*$1-3 billion*	*Over $3 billion*
1	1	–	–	–	–	1
2	12	7	7	3	2	1
3	30	29	40	42	40	31
4	12	7	35	39	48	43
5	8	6	17	15	37	56
6	1	1	9	8	11	45
7	1	1	4	4	10	11
8	–	1	–	2	2	6
9	–	–	–	1	1	2
11	–	–	–	1	–	–
Totals	65	52	112	115	151	196
Median committee size	3	3	4	4	4	5
1978 medians	3	3	3	3.5	4	5

[1]Financial companies are measured by total assets; all other companies are measured by sales.

Table 4: Affiliation or Background of Audit Committee Members—2,902 Reported Members of 692 Committees

Affiliation or Background		*Number of Directors*	*1987 Percent*	*1978 Percent*
Active chief executive of nonfinancial firm		771	27%	26%
Other high-level executive of nonfinancial firm		264	9	12
Retired executive (*not former employee* of the reporting company):				
Chairman, president or CEO, nonfinancial firm	334			
Other high-level executive, nonfinancial firm	107			
Chairman, president or CEO, financial firm	111			
Other high-level executive, financial firm	45			
Other retired person	77			
Total retired executives		674	23	9
Attorney		191	7	8
Academic		182	6	5
Banker		126	4	9
Former employee of the company		109	4	5
Investment banker		107	4	4
Private investor		77	3	1
Present employee of the company		63	2	1
Representative of major customer		58	2	5
Financial consultant or advisor		46	2	1
Consultant *to the company*		38	1	–
Former government official		41	1	–
Professional director		26	1	6
Representative of major supplier		5	–	1
All other (not retired)		124	4	7
Totals		2,902	100%	100%

representatives, comprising 27 percent of the audit committee members surveyed in 1987. Second in line are retired nonfinancial CEOs, followed by high-level active executives in nonfinancial firms. Looked at another way, the figures indicate that 47 percent, or just about half, of the committee members come from the upper echelons of nonfinancial management.

There are some changes. There is a large percentage increase in the number of retired executives serving on audit committees: 23 percent, presently, compared to 9 percent in 1978. (These figures exclude executives who have retired from the reporting company itself.) Conversely, the presence of bankers on audit committees appears to have fallen markedly from 9 percent to 4 percent. This change coincides with the drop shown by various surveys in the overall number of bankers on boards, especially of representatives of banks with major business connections with the company. It may represent a decision to adhere more closely to the spirit of the guidelines for audit committee independence put forth by the New York Stock Exchange.

The Level of Independence of Members

The New York Stock Exchange guidelines were issued by the Exchange as an explanatory supplement to its policy requiring listed companies to have audit committees. This policy, which became fully effective in 1978, is reproduced on page 9, together with the "Supplementary Material," which spells out guidelines for determining the independence of certain kinds of directors. These guidelines have undoubtedly influenced the selection process for audit committee members.

Many audit committee charters require audit committee members to meet a standard of independence, which is typically defined. Often this standard is that of the New York Stock Exchange, either quoted verbatim, in part, or paraphrased as follows:

> "... none of whom [committee members] may be an officer or employee of this corporation or any of its subsidiaries and all of whom shall, in the opinion of the chairman [of the company] and the board of directors, be free from any relationship which would interfere with the exercise of their independent judgment as a member of the Audit Committee."
>
> —A financial firm

Other charters simply require that all (or, in some cases, a majority) of the members be outside directors. One nonfinancial service company's charter bars certain executives from serving: "Membership on the committee by the president, executive vice president, treasurer, or secretary is specifically prohibited." Another firm excludes all former company executives, which is a stricter standard than that of the New York Stock Exchange. In contrast, a company in the energy business that limits membership to outside directors also reports that: "The chief executive officer and the vice president-controller serve as ex-officio nonvoting members of the committee." (In many other companies these executives are present at audit committee meetings, but not as members.)

Table 5 lists most of the corporate backgrounds specified by the NYSE that would or could compromise a director's ability to think and act independently as an audit committee member. The table shows how many survey companies report having directors with such backgrounds as a member of the audit committee. Note that only 10 percent have a committee member who represents a bank that customarily does business with the company; this figure was 23 percent in 1978. The percent of committees on which one or more former employees of the company serve dropped from 19 percent to 13 percent. In fact, figures for most of the potentially nonin-

Table 5: Companies Having Potentially "Nonindependent" Directors on Audit Committee, 692 Companies[1]

Relationship of Director to Company	*Number of Companies With at Least One Such Director on Committee*	*1987 Percent*	*1978 Percent*
Former employee	93	13%	19%
Attorney[2]	80	12	10
Banker[3]	68	10	23
Investment banker[4]	48	7	9
Employee	44	6	3
Major customer	33	5	9
Major supplier	5	1	2

[1]The relationships in the table are among those discussed in the "Supplementary Material" section of the New York Stock Exchange's policy statement on the audit committee.
[2]Affiliated with company's outside counsel.
[3]Representing bank customarily serving the company.
[4]Providing service to the company.

dependent directors listed in the table have decreased since the last report.

Since many survey companies are not listed on the NYSE, the high compliance with the Exchange's guidelines indicated in Table 5 is evidence that many non-Exchange companies believe in independent committees and voluntarily abide by strict membership standards. (As noted in Chapter 1, another securities exchange—NASDAQ—now has an audit committee requirement, for companies traded on its National Market System, fully effective as of February 1, 1989. A majority of independent members on the committee is part of the requirement; see the adjacent box.)

The survey data provide further detail concerning the former and present employees serving on audit committees. Over half of the 107 former employees identified by title were chairperson, president, or chief executive officer (including combinations of these titles) prior to their retirement from the company (Table 6). The pattern for *present* employees is similar (Table 7).

Who Selects Members and the Chairman

Many of the charters provided by study participants specify who selects the members of the audit committee; some also specify how the committee chairperson is to be chosen.

The charters reveal that, as with board committees in general, the members of the audit committee are commonly appointed by the board as a whole. However, the board chairperson—who is typically also the chief executive—frequently initiates the choices by way of recommendations to the board.

In many companies the board selects the committee chairperson as well as committee members. In contrast, some companies permit the committee members to choose a chairman. A third method, reported by a few firms, empowers the board chairman to pick the audit committee chairman.

The NASDAQ Audit Committee Requirement for Certain Listed Companies

In 1987 the National Association of Securities Dealers adopted a set of SEC-approved corporate governance rules applicable to those companies trading on NASDAQ's National Market System. The effective date for compliance (for companies listed at the time the rules were adopted) is February 1, 1989. Among the requirements are the following (under Part III, Section 5 of the Amended Section D to the NASD Bylaws):

"Independent Directors

Each NASDAQ/NMS issuer shall maintain a minimum of two independent directors on its board of directors. For purposes of this section, "independent director" shall mean a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship that, in the opinion of the board of directors, would interfere with the exercise of independent judgment in carrying out the responsibility of a director.

Audit Committee

Each NASDAQ/NMS issuer shall establish and maintain an audit committee, the majority of the members of which shall be independent directors."

NASDAQ thus joins the New York Stock Exchange in requiring an audit committee and in emphasizing independent membership for the committee. A NASDAQ Information Bulletin dated March 16, 1988, provides guidance for determining whether a particular director meets the independence tests. The standards set forth are much like those established by the New York Stock Exchange in its audit committee requirement policy (see box on p. 9).

Table 6: Titles of Former Employees Serving on Audit Committees[1]

Title	No. of Times Mentioned
Former chairperson/president/ceo	55
Former vice president	17
Former senior/executive vice president	14
Former chairperson/president/ceo of subsidiary or affiliated company	9
Other former employee	12
Total	107

[1]Ninety-three companies (13 percent) report having at least one former employee serving on the audit committee; in 12 of these companies there is more than one such member.

Table 7: Titles of Present Employees Serving on Audit Committees[1]

Title	No. of Times Mentioned
Chairperson/president/chief executive officer	31
Chief financial officer	9
Other	20
Total	60

[1]Forty-four companies (6 percent) report having at least one employee serving on the audit committee; in 12 of these companies there is more than one employee member.

New York Stock Exchange Policy on Audit Committees[1]

Audit Committee Regulations

Exchange Policy—Each domestic company with common stock listed on the Exchange, as a condition of listing and continued listing of its securities on the Exchange, shall establish no later than June 30, 1978 and maintain thereafter an Audit Committee comprised solely of directors independent of management and free from any relationship that, in the opinion of its Board of Directors, would interfere with the exercise of independent judgment as a committee member. Directors who are affiliates of the company or officers or employees of the company or its subsidiaries would not be qualified for Audit Committee membership.

A director who was formerly an officer of the company or any of its subsidiaries may qualify for membership even though he may be receiving pension or deferred compensation payments from the company if, in the opinion of the Board of Directors, such person will exercise independent judgment and will materially assist the function of the committee. However, a majority of the Audit Committee shall be directors who were not formerly officers of the company or any of its subsidiaries.

Supplementary Material—In order to deal with complex relationships that may arise, the following guidelines are provided to assist the Board of Directors to observe the spirit of the [above] policy in selecting members of the Audit Committee.

A director who has been or is a partner, officer or director of an organization that has customary commercial, industrial, banking or underwriting relationships with the company which are carried on in the ordinary course of business on an arms-length basis may qualify for membership unless, in the opinion of the Board of Directors, such director is not independent of management or the relationship would interfere with the exercise of independent judgment as a committee member.

A director who, in addition to fulfilling the customary director's role, also provides additional services directly for the Board of Directors and is separately compensated therefor, would nonetheless qualify for membership on the Audit Committee. However, a director who, in addition to his director's role, also acts on a regular basis as an individual or representative of an organization serving as a professional advisor, legal counsel or consultant to management, would not qualify if, in the opinion of the Board of Directors, such relationship is material to the company, the organization represented or the director.

A director who represents or is a close relative of a person who would not qualify as a member of the Audit Committee in the light of the policy would likewise not qualify for the committee. However, if the director is a close relative of an employee who is not an executive officer or if there are valid countervailing reasons, the Board of Directors' decision as to eligibility shall govern.

While Rule 405 under the Securities Act of 1933 may be helpful to the Board of Directors in determining whether a particular director is an affiliate or a close relative for purposes of this policy, it is not intended to be so technically applied as to go beyond the spirit of this policy.

[1] Quoted from Section 3, Corporate Responsibility, of the Exchange's Listing Standards and Procedures.

Table 8: How Many Companies Rotate Members and Chairmen of the Audit Committee, by Industry Category, 687 Companies

	Companies that Rotate Membership		*Companies that Rotate Chairmanship*	
Industry Category	*Number*	*Percent*	*Number*	*Percent*
Manufacturing	70	26%	76	29%
Financial	58	33	47	26
Nonfinancial service	49	20	47	19

A few companies have adopted other selection procedures. For example, in one manufacturing firm it is the board nominating committee that recommends who shall serve on the audit committee and who shall chair it. (The primary role of nominating committees, which are usually composed entirely of outside directors, is to find potential candidates for membership on the full board, but in some companies, such as this one, the nominating committee also plays a role in the assignment of directors to service on the various board committees.)

Rotating Members and the Chairmanship

Rotating service on the audit committee is reported by 26 percent of the survey companies (Table 8), compared to 20 percent in the 1978 survey. The following reasons have been offered for having turnover on a regular basis:

- It spreads the burden of time involved in serving on the committee; this time can be considerable.
- It ensures the introduction of fresh ideas.
- It fosters the independence of the committee, whose

members might otherwise tend, in time, to identify with particular management personnel or problems or with policies endorsed or even initiated by the committee.

The prevalence of this practice differs markedly among the three industry groups surveyed. The percentage of companies that have adopted this policy ranges from a high of 33 percent in the financial sector to a low of 20 percent among nonfinancial service companies (Table 8).

Overall, 25 percent of the companies rotate the chairmanship of the committee. Unlike the sizable increase shown for rotation of members, rotating the chairman's job is hardly more common than 10 years ago.

Table 9 presents information on rotation policy according to size of company. It shows that the larger the company, the more likely it is that rotation is followed. Note that a third of the biggest firms report having rotation policies.

A common system of rotation uses fixed terms of committee service—three years, for example—and staggers terms so that new members join the committee in an orderly way. But some companies specify only in general terms that rotation shall be followed, leaving the method of implementation undefined, an approach that allows for flexibility. In many cases, rotation is a policy for all board committees, not just the audit committee.

For examples of various approaches to rotation policies for audit committee membership, see the box below.

Table 9: How Many Companies Rotate Members and Chairmen of the Audit Committee, by Company Size, 686 Companies

	Companies that Rotate Membership		*Companies that Rotate Chairmanship*	
Company Size Category	*Number*	*Percent*	*Number*	*Percent*
Under $100 million	11	17%	9	14%
$100-199	9	17	9	17
$200-499	19	17	27	24
$500-999	30	26	26	23
$1-3 billion	42	28	38	25
Over $3 billion	66	34	61	31

Examples of How Companies Provide for Rotation of Audit Committee Membership

"The Audit Committee shall be appointed by the board of directors from among its "outside" members. They are to serve three-year terms. It would be appropriate for its terms to be staggered so as to call for no more than one member to be replaced in one year."

—A nonfinancial service company

"The term of service of the members of the Committee, who shall serve at the pleasure of the board, will be staggered so as to provide continuity of a majority. The chairman of the Audit Committee, appointed by the board, shall not serve in that capacity for more than three years."

—A manufacturing company

"Nominate a new member for the committee each year from among outside directors with a view to rotating three members over a three-year period."

—A manufacturing company

"Where feasible, the various committees should practice a policy of revolving membership—without, however, losing the continuity of experience and knowledge gained by the members of such committees."

—A financial company

Chapter 3

Committee Meetings and Other Working Procedures

This chapter presents detailed information about audit committee meetings: their frequency and length, how agendas are established, who attends in addition to committee members, what is done with meeting minutes and who acts as secretary. It also discusses providing staff help and addresses how formally and frequently the committee reports on its activities to the full board.

Frequency of Committee Meetings

Among those surveyed, the median frequency of audit committee meetings is three times a year both for manufacturing and nonfinancial service firms, unchanged from the 1978 survey. The higher median of four meetings a year for financial firms also is unchanged (Table 10). Table 11 shows that audit committees of large companies meet more frequently than their smaller-company counterparts.

Most audit committees meet in accordance with a predetermined schedule. In 198[illegible], however, 16 percent of those surveyed—107 committees—held at least one ad hoc meeting. Two-thirds involved just one session; the remaining one-third, from two to six meetings not on the agenda at the beginning of the year.

Many audit committee charters now require that the committees meet with the outside auditors. About 90 percent of committees hold such meetings at least twice a year, more frequently in almost half the companies (Table 12). The survey respondents also confirm that confidential communication between committee and auditors receives considerable priority. A majority of committees have at least two private sessions with the outside auditors each year (Table 13). In most companies, it is clearly understood, however, that the auditors may have private hearings with the committee whenever necessary.

Table 10: Frequency of Audit Committee Meetings, by Industry, 689 Companies

Number of Meetings Per Year	Manufacturing		Financial		Nonfinancial Service	
	No. of Companies	Percent	No. of Companies	Percent	No. of Companies	Percent
1	9	3%	9	5%	6	3%
2	89	33	30	17	80	33
3	77	29	23	13	82	34
4	66	25	64	36	57	24
5	20	7	18	10	10	4
6	5	2	11	6	2	1
7	1	–	3	2	1	–
8	2	1	7	4	2	1
9	–	–	4	2	1	–
10	–	–	2	1	1	–
12	–	–	5	3	–	–
13	–	–	2	1	–	–
Totals	269	100%	178	100%	242	100%
Median frequencies:	3		4		3	
1978 medians:	3		4		3	

Table 11: Frequency of Audit Committee Meetings, by Company Size, 688 Companies

Number of Meetings Per Year	Company Size Categories					
	Under $100 million	$100-199 million	$200-499 million	$500-999 million	$1-3 billion	Over $3 billion
1	7	4	3	3	6	1
2	29	26	42	33	39	30
3	3	12	34	38	50	45
4	23	5	26	27	32	73
5	–	3	4	5	12	24
6	–	1	1	2	5	9
7	–	–	–	1	2	2
8	2	–	–	1	2	6
9	–	–	–	1	1	3
10	–	–	–	1	1	1
12	–	–	1	2	1	1
13	–	1	–	–	–	1
Totals	64	52	111	114	151	196
Medians:	2	2	3	3	3	4

Table 12: Annual Frequency of Committee Meetings with Outside Auditors

Number of Meetings with Outside Auditors	No. of Companies	Percent
1	75	11%
2	286	42
3	168	25
4	116	17
5	24	3
6-9	13	2
Totals	684	100%

Median and Mode: 2

Table 13: Meetings Annually with Outside Auditors Without Management Present At Least Part of the Time

Number of Meetings Without Management Present	No. of Companies	Percent
0	100	15%
1	165	25
2	229	34
3	101	15
4	64	10
5	8	1
8	1	–
Totals	668	100%

Audit committee charters frequently specify that the internal auditors shall have unimpeded private access to the committee as needed. And there are now numerous companies in which the head of internal auditing has a formal reporting relationship to the committee or to its chairman. (See Chapter 4 for more information.)

Meeting Agendas

Audit committee meetings are now conducted according to written agendas in 92 percent of the responding companies. This reflects a substantial increase in all three industry categories (Table 14). An exception, within the financial industry, is banking, where 90 percent of the 1978 respondents already followed this practice.

Like many other practices discussed in this report, the use of written agendas is somewhat more prevalent in large companies than in smaller ones:

Size Category	Percent of Companies Using Written Agenda
Under $100 million	79%
$100-199	79
$200-499	90
$500-999	94
$1-3 billion	97
Over $3 billion	96

Most of the companies that prepare an agenda for audit committee meetings also circulate it ahead of time to at least some of the people who will attend. This is more prevalent in bigger companies than smaller ones (Table 15), and shows little change from the 1978 survey:

Those Receiving an Agenda	Percent of Companies Using Agendas that Circulate Them	
	1987	1978
Members of the committee	93%	91%
Company personnel who will attend	83	83
Outside auditors who will attend	80	82

Some companies prepare an agenda separately for each audit committee meeting as it approaches. In other cases, agendas for all scheduled meetings for the coming year—or even further ahead—are drawn up at the same time. It is often possible to draft these advance agendas in some detail, as audit committee meetings tend to be geared to specific stages or events in the financial and internal control cycle. Agendas can also be modified if necessary, as a particular meeting approaches.

Examples of annual schedules and meeting agendas are shown in the box on p. 14. A larger selection appears in Appendix 2.

Table 14: Percent of Companies that Prepare a Written Agenda for Audit Committee Meetings, 1987 and 1978, by Industry Category

Industry Category	*1987*	*1978*
Manufacturing	93%	76%
Financial	93	78
Nonfinancial service	91	75

Who Determines Agendas

As in the 1978 survey, responding executives singled out the chairman of the committee as having the primary role in establishing agendas, by a wide margin (Table 16). Likewise, the chief financial officer was again cited as second in

Table 15: Percent of Companies Using Written Agendas that Distribute Them in Advance, to Various Attendees, by Company Size[1]

	Agenda Is Distributed to:		
Company Size Category	*Committee Members*	*Company Personnel Who Will Attend*	*Outside Auditors Who Will Attend*
Under $100 million	72%	55%	63%
$100–199	75	58	60
$200–499	81	75	68
$500–999	82	73	68
$1–3 billion	90	83	85
Over $3 billion	92	85	78

[1] Ninety-two percent of total respondents prepare written agendas.

Table 16: Summary Ranking of Those Involved in Determining Agenda for Audit Committee Meetings, 585 Companies

	No. of Times Mentioned		
Individual or Group	*Alone[1]*	*With Others*	*Total*
Committee chairman	84	273	357
Chief financial officer or controller	57	76	133
Internal auditor	44	61	105
Corporate or committee secretary	13	34	47
Outside auditors	12	4	16
Chairman/president/chief executive	3	13	16
Committee members	12	–	12
Other people or combinations of people	–	–	88
Totals	225	461	774[a]

[1] "Alone" means that the person indicated was the only one mentioned; it does not necessarily mean there is no participation by others at times.

[a] Total exceeds number of companies because designation of more than one person was permissible.

Examples of Annual Audit Committee Meeting Schedules and Agendas

"Meetings will be regularly scheduled in February, July and November and will include on the agenda the following items:

A. February Meeting:
   - Review of audit results.
   - Review of internal audit results and characterization of control.
   - Review of audit fees and recommendation of outside auditor.
   - Update on control concerns.
   - Update on significant balance sheet changes from November meeting.

B. July Meeting:
   - Quality of earnings.
   - Review of audit plans.
   - Review of six months internal audit results.
   - Update on control concerns.

C. November Meeting:
   - Review of internal audit plans and performance versus current year's plan.
   - Balance sheet review based on September 30 balance sheet, including:
     1. Deferred charges.
     2. Nonproductive assets.
     3. Prepaid expenses and other current assets.
     4. Other deferred liabilities and credits.
     5. Tax reserves presented by the General Tax Officer.
     6. Contingent liabilities presented by General Counsel. Review of key personnel and staffing levels in the controllership function."

—A petroleum company

"The Committee shall hold three regularly scheduled meetings per year as follows:
1. February—Meet with independent auditors to review the audit of the prior year's results.
2. June—Review internal audit services. Review independent audits of those subsidiaries completed after the February meetings. Determine whether to retain or terminate independent auditors for the following year and prepare an appropriate recommendation to the board.
3. September—Meet with independent auditors to discuss scope of upcoming year-end audit.
4. The chairman of the committee may call special meetings as may be required."

—A public utility

"The Committee shall meet at least once each quarter and at such other times as may be requested by its chairman. Required meetings with the independent auditor are as follows:
- March—Review the audit results, the auditor's opinion, the auditor's perception of the adequacy of the financial staff, and other observations.
- September—Review the actual fees for the prior year and the scope and estimated fees for the coming year.
- November—Review significant management letter items."

—A petroleum company

importance. The internal auditor has vaulted into third place, replacing the outside auditors (now a distant fifth). In fact, almost as many companies name the internal auditor as name the CFO. This change reflects, in part, the upgraded status of internal auditing in the corporate financial picture over the last decade. This is consistent with the greater emphasis audit committees now give to the internal auditing function as a means of strengthening financial controls and ensuring financial integrity.

To the extent that outside auditors appear to participate less in deciding in which areas audit committees will focus their time and effort, it would seem to be a change for the better. It suggests greater maturity and sophistication on the part of audit committees. At the same time, it strengthens the image of the auditors' independence from client involvement, which has become so important to the concept of objective audits.

On the other hand, a few charters include statements giving the outside auditors the right to have their concerns addressed by the committee. These specify, for example, that the audit committee must:

- "Review and discuss any other matters which the independent accountants and committee members choose to bring to the attention of the committee."
- "Meet periodically with the independent certified public accountant of the corporation to review ... any other matters deemed necessary by the CPAs to be brought to the board of directors' attention."

- And "Upon the request of the independent public accountants or the company's general auditor, the chairman of the Audit Committee shall convene a meeting of the committee to consider any matters such auditors believe should be brought to the attention of the committee, directors or stockholders."

Who Attends Meetings

Audit committee meetings usually include nonmembers. A common pattern is to have a core group—the committee, plus auditors and certain key executives—who are expected to attend every meeting, and a second group of people, designated corporate personnel, who are invited to be present as needed. This may be backed up with a blanket authorization enabling the committee to require the presence of anyone deemed necessary fo. .ts deliberations.

Most often named in the core group are representatives of the outside auditing firm and the company's chief internal auditor. Less frequently cited are the chief financial officer and the company's general counsel. In some cases, these executives are on the "as-invited" list, as are the chief executive officer, the chief operating officer, the controller (if not the chief auditor), the chief compliance officer, and contract performance auditors. In some instances, the audit committee charter empowers the committee chairman to choose who shall attend a given meeting. Excerpts from committee charters spelling out who shall attend committee meetings appear in the adjacent box.

Minutes of Meetings

In the 1978 survey, 89 percent of the companies reported that their audit committees kept formal minutes. The current figure is even higher: 96 percent. The contents of the minutes appear to have changed, however, away from detail and toward summaries or highlights of what took place (see below).

Degree of Detail of Minutes	Percent of Companies	
	1987	1978
Detailed as to topics, sense of discussion, action taken	21%	38%
Comprehensive, but an outline or summary, not detailed	48	43
Only highlights or major actions	30	19

A little over a half of the committees in the previous survey that kept formal minutes submitted them to the full board and this pattern persists. Among boards that receive audit committee minutes, only 39 percent formally approve them; for the majority, minutes are simply a means of keeping the board informed.

Board approval of committee minutes is least prevalent in the largest companies:

Company Size	Percent of the Boards that Receive Meeting Minutes that Approve Them
Under $100 million	56%
$100-199	47
$200-499	50
$500-999	44
$1-3 billion	18
Over $3 billion	33

Committee Charter Excerpts: Who Shall Attend Meetings

"In addition to the committee members and Corporate Secretary, all meetings will be attended by representatives of the independent accountants and the Internal Auditor and Corporate Controller. Others may attend, if appropriate, as determined by the committee chairman."

—A manufacturing company

"All members of the Audit Committee plus the chief executive officer, the chief operating officer, the chief financial officer, the controller, the general auditor, the general counsel, the corporate secretary and two partners from the outside audit firm."

—A manufacturing company

"Members of the Audit Committee, and as requested by the chairman for all or part of any meeting: other directors, members of management, the chief auditors, contract performance auditors and representatives of the independent accountants."

—A manufacturing company

"In addition to the committee members, these meetings normally will be attended by representatives of the independent public accountants, by the director of internal audit and by the corporate general counsel. The chief financial officer, as well as the chairman and the president, may attend, except for portions of the meetings where their presence would be inappropriate, as determined by the committee chairman."

—A nonfinancial service company

"The chairperson of the bank, president, chief financial officer and internal auditor shall attend as requested, except for portions of the meetings where their presence would be inappropriate as noted herein and as determined by the members of the committee or chairperson.

"The Audit Committee is authorized to request the presence at any meeting of any one who could contribute substantively to the subject of the meeting."

—A financial company

Some examples of provisions for recording and distributing audit committee minutes, taken from committee charters, appear in the adjoining box.

Who Acts As Committee Secretary

The corporate secretary acts as secretary to the audit committee in about half the participating companies, as was the case in the 1978 survey (Table 17).

However, there have also been changes. The internal auditor is now the second most popular selection for committee secretary, displacing the choice of a committee member, which is now third and far less common than 10 years ago. This shift is yet another indication of the growth of internal auditing's involvement with the audit committee. It is consistent with the finding that the internal auditor now plays a stronger role in setting the agenda for committee meetings.

Staff Assistance

In 83 (12 percent) of the 692 surveyed companies, corporate personnel are formally assigned to the audit committee to provide staff assistance, such as clerical or legal service or advice, on a part-time or full-time basis. This incidence is virtually unchanged from the 1978 survey. The assignment of staff help to the audit committee is also still somewhat more prevalent in financial companies than in other kinds of firms:

Industry Group	Percent of Companies Providing Staff Assistance
Manufacturing	12%
Financial	15
Nonfinancial service	10

Committee Charter Statements Specifying How Minutes of Meetings Shall Be Kept and Distributed

"The corporation's auditor will be designated as secretary to the committee. Minutes of the meetings of the committee will be kept by the secretary. These minutes will be approved at the next meeting of the committee and presented to the board of directors."

—A bank

"Minutes will be prepared covering each meeting of the committee and submitted to the board for approval and inclusion with the minutes of the board meeting."

—An energy company

"The minutes of the meeting shall be detailed as to topics, the sense of the discussion and the actions taken. The minutes shall be kept by the corporate secretary and in his/her absence by a member appointed by the chairperson.

"The minutes of each meeting shall be sent to all audit committee members and a written report on significant findings shall be made by the chairperson to the board of directors."

—A financial company

"Minutes of each meeting are to be prepared by the secretary of the corporation, copies to be sent to committee members with the original filed in the corporate archives."

—A manufacturing company

"Further resolved, that the independent accountants shall prepare minutes of the Audit Review Committee's meetings and, after approval by the chairman of the Audit Review Committee, such minutes shall be distributed to all directors."

—A financial company

Table 17: Person Acting as Secretary of the Audit Committee, 680 Companies

Function or Title	*No. of Times Mentioned*	*1987 Percent*	*1978 Percent*[1]
Corporate secretary	336	49%	45%
Internal auditor	136	20	7
A committee member	86	13	27
Chief financial officer or treasurer	37	5	6
Controller	31	5	7
Corporate counsel	5	1	2
Committee chairman	1	–	2
Corporate executive, title unspecified	1	–	1
Outside auditor	1	–	1
Other	46	7	2
Totals	680	100%	100%

[1]Based on 612 companies.

In about 90 percent of firms assigning staff assistance, it is part-time and arranged as the need arises. Only nine companies reported having someone on full-time assignment to the audit committee; in four of these, the full-time person can draw on additional help, as needed.

About half of the companies that assign corporate staff to the audit committee commit just one person. Twenty-five percent make two people available. The remainder assign three or more people to this task at times. These figures are little changed from 1978.

A few committee charters also specify that all employees are required to cooperate with committee members. This kind of broad mandate for cooperation underscores the message that the audit committee has the authority to demand more help, if needed. Also, as described in Chapter 5, many committees have the authority to hire outside expert help or advice.

See the box on this page for some charter excerpts about designating staff assistance to the committee.

Reporting to the Full Board

Like any board committee—perhaps even more than most—the audit committee is expected to convey what transpires at its meetings to the full board. Almost every audit committee in the survey (98 percent) gives a formal accounting of its activities at least once a year, essentially unchanged from the 1978 survey. However, the frequency of reports to the board has risen, from a median of two for all companies in 1978 to three reports a year in 1987; only 14 percent report only once a year (Table 18).

Meeting Length and Other Time Requirements

A questionnaire sent to chief executive officers asked how much time they put in, over a one-year period, as an audit committee member. For the 49 respondents, meeting preparation was more time consuming than attendance. The median yearly preparation time—studying advance materials and making telephone calls—was eight hours, but the most frequently mentioned figure was ten hours. For meetings, the median was six hours a year; and the most frequently mentioned time was eight hours.

When the attendance figures are divided by the median meeting frequency of three a year (four for financial companies), it is evident that meetings of from two to three hours are common for audit committees (and that preparation time for each meeting is slightly greater than that).

The *total* annual hours spent by each of 49 respondents in serving on one audit committee were computed, including preparation and attendance time and travel time for meetings that did not coincide with meetings of the full board. The total ranged from as few as four hours a year, to as many as 70. The median was 18; 25 percent reported 30 or more hours. These figures pertain to the audit committee of one board only; they do not include time for any other committees or for full board service.

Table 18: How Often the Audit Committee Reports Formally to the Full Board Annually, 664 Companies[1]

Number of Reports to Board	*No. of Companies*	*1987 Percent*	*1978 Percent[2]*
1	93	14%	22%
2	198	30	31
3	149	22	18
4	165	25	22
5-6	39	6	6
7-12	18	3	1
Varies/as needed	2	–	–
Totals	664	100%	100%
Medians		3	2

[1]Excludes 13 companies whose audit committees have no requirement to report formally to the board.

[2]Based on 595 companies.

Charter Excerpts Designating Staff Assistance to the Audit Committee

"Administration support to the Audit Committee will be provided by the senior vice president-finance, senior vice president, secretary and corporate counsel, treasurer, corporate controller and corporate manager of internal audit."
—A manufacturing company

"The manager-auditing of the Company shall be the staff assistant assigned to the Audit Committee."
—A nonfinancial service company

"Staff Support: Corporate General Auditor."
—A manufacturing company

"Such directors shall have the power to employ such assistants in making such examination as they may deem necessary and may arrange for the employment of assistants for the next succeeding calendar year."
—A financial company

Chapter 4

The Committee's Relationship with External and Internal Auditors

An audit committee deals with people inside and outside the company in the normal course of carrying out its duties. Those contacts can be grouped as follows:

- The full board of directors;
- The chief executive officer and other members of corporate management;
- The chief internal auditor; and
- Representatives of the outside auditing firm.

The committee's dealings with outside and inside auditors are the essence of its role. Importantly, there have been some changes in these relationships since the 1978 survey.

Outside Auditor Independence

By 1978, as the previous study showed, the relationship of audit committees to outside auditing firms had already undergone significant changes from the simple monitoring that had once sufficed. Committees were asking more questions about the audit (both before and after) and meeting more often with the auditors. And these meetings increasingly included occasions on which no representative of management was present. The study made it clear, in fact, that the relationship of auditing firms to their client companies had been shifting, in the direction of primary accountability to the board of directors—via the audit committee—rather than to corporate management.

Examining charters submitted in connection with this report leads to the conclusion that this trend has continued. Many charters now emphasize that the audit committee has a duty to support and ensure the independent status of the accounting firm (see box on p. 20). Private meetings between the auditors and the committee are one means of accomplishing this goal, and they are now required in many charters.

For example, "In discharging its responsibilities, the committee will periodically meet with the company's independent accountants without the presence of any company officer or employee." And, "At all meetings of the Audit Committee, sufficient opportunity should be made available for the independent auditors to meet with the members of the Audit Committee without members of management present."

Survey responses reveal that private meetings with outside auditors have become the norm; 85 percent of the surveyed committees have at least one such meeting every year; 60 percent have two or more private sessions.

Many audit committees are currently concerned with another aspect of the outside auditing firm's independence, the delicate issue of whether non-audit management consulting by the auditor might weaken the firm's independence. Fear has been voiced by the SEC and other organizations that an accounting firm might find it difficult to oppose management over a controversial accounting practice if doing so jeopardized lucrative management consulting projects (as well as the audit work). With this in mind, many audit committees are asked to review proposed non-audit consulting work to be done by the auditing firm to assess whether it might present a threat to the firm's objectivity. The charter of a non-financial service company, for example, calls for the audit committee to: "Review the scope of any non-audit services to be performed by the independent auditors, as well as related fees, and consider the possible effect that these non-audit services could have on the independence of such auditors." One charter specifies that the committee need review only *substantial* fees (more than $50,000) for non-audit services.

Some committees have the power to *approve* or *disapprove* of contracting the independent auditor to perform non-audit services. In the current survey, 37 percent of responding firms have a procedure for advance approval and, in most cases, the audit committee plays the key role. (Other companies involve the full board, the executive committee, the chief executive officer, and/or the chief financial officer.) The current figure reflects a considerable increase over the 15 percent reported in the 1978 survey. However, only two percent of those utilizing advance approval said that a non-audit proposal had been turned down in the past five years.

Several approaches are used to screen non-audit services for advance approval. The most basic is to have the committee consider such items along with the proposal for the an-

nual audit and to make a decision or recommend one to the board yearly. The following practices are also reported:

- *Follow-up during the year*: Some committees review non-audit service activity during the year as well as before the auditing firm begins its audit. Some participants noted quarterly reviews or discussions on the topic at every committee meeting. This approach provides for unforeseen items.
- *Dollar thresholds*: A number of firms require committee approval for expenditures that exceed a specialized dollar limit. Some of these set a ceiling on total expenditures, others set both a total maximum and limits for individual or department expenditures. An example: $200,000 total, $50,000 for individual items. In surveyed firms, approval thresholds ranged from as low as $15,000 to as high as $500,000; most were $200,000 or less.
- *A percentage limit*: A few companies require the approval of non-audit services that exceed a specified percentage of the total fees payable to the auditors; 10 percent and 25 percent were mentioned. This approach attempts to keep non-audit fees from reaching a level of importance to the auditor that could result in a loss of independence.

Companies note that both the type of service and the size of the fee are taken into consideration.

Examples of Charter Provisions Emphasizing Auditor Independence

"RESOLVED, that the functions of the Audit Committee shall be:

Support the independence of the corporation's independent auditors and the objectivity of the corporation's financial statements;

"At least annually, review and make a determination of the independence of the independent auditors, and report thereon to the board.

"Assure that:

a. The corporate environment provides freedom for proper audit independence and for the auditors to act.
b. Sufficient resources are allocated to develop and maintain an effective audit program."

—An industrial products company

"This Committee shall establish direct communication between the independent auditors and the board of directors and between the corporation's internal auditors and the board of directors to assure that the independent and internal auditors have the freedom, cooperation, and opportunity necessary to accomplish their functions."

—A financial company

"Confirm and assure the independence of the internal and external auditors."

—A gas and electric utility company

"[The committee] is to be the board's principal agent in assuring the independence of the corporation's independent accountants, the integrity of management and the adequacy of disclosures to stockholders. The opportunity for the independent accountants to meet with the entire board of directors as needed is not to be restricted, however."

—A diversified services and manufacturing company

"Provide for direct communication between the board and the independent accountants in order to strengthen their independence and objectivity."

—A retail merchandising company

Changing Auditors

In the 1978 survey, five percent of responding firms reported they had switched auditors in the preceding three years. The 1987 figure is higher, at eight percent. (See box on p. 21 for brief descriptions of why some firms chose to switch.) Table 19 shows that smaller companies were more involved than big ones in changing auditors.

The audit committee was actively involved in most of these auditor changes, sometimes from beginning to end, as the following shows:

Committee Role in Changing Outside Auditor	No. of Mentions
Interview representatives of auditing firms being considered (12 companies) or screen audit proposals (6 companies)	18
Review and approve management's recommendation of a new firm	15
Recommend a new firm to the full board	14
Approve the scope and procedures of the search	4
Recommend the change of firms.	1
Other (discussed with management, kept informed, reviewed reasons for change, aided in selection)	3

Base: 43 companies

Closer Ties to Internal Auditing

Chapter 3 points out that the internal auditor has become more involved with the audit committee, by setting meeting agendas and by acting as committee secretary. The survey produced further evidence of the closer working relationship between audit committees and the internal audit function. Just as access to the audit committee by the outside auditing firm has been strengthened, so too has access by the chief internal auditor. It is more common now for charters to require the committee to meet in private with the internal auditor (with no members of management present),

or to state that the committee will be available to the internal auditor when necessary, or both.

Another way companies support the independent status of the internal auditing function is to specify in writing that the audit committee must have a say—or, at a minimum, must be consulted and thoroughly informed—when there is to be a change in internal auditors (see box). Some committees are also charged with monitoring the pay level of the head of internal auditing. These links give the internal auditor an ally in high places and presumably discourage management from trying to undermine or compromise his/her sense of independence. The Treadway Commission included these forms of monitoring among its recommendations.

Another major trend is the increasing extent to which internal auditors formally report to the audit committee. In the 1978 survey, 25 percent of participating firms engaged in this practice. By 1987, this was true of almost *half* (Table 20). The box on p. 22 gives examples of how some companies described this relationship.

Note in Tables 21 and 22 that reporting to the audit committee is much more prevalent in financial companies than in other industries, and that large and medium size companies follow this practice more often than smaller firms.

Perhaps the most significant indicator regarding the growing relationship between audit committees and the internal auditing function over the past ten years lies in changes in the function attributable to that relationship. A large majority of the chief executives and chief financial officers contributing to the study said that the activities of this committee have benefitted internal auditing, as follows:

Effect on Internal Auditing	Percentage of CEO/CFO Respondents Who Believe Audit Committees Have Brought About:	
	Some change	Major change
Improvement in procedures or practices	60%	27%
Improvement in effectiveness, thoroughness or reliability	60%	21%

Base: 121 companies

Table 19: Companies that Changed Auditing Firms in the Past Three Years, by Company Size[1]

Company Size	*No. of Companies*	*Percent of Companies in Category*
Under $100 million	10	15%
$100-199	10	19
$200-499	11	10
$500-999	9	8
$1-3 billion	4	3
Over $3 billion	8	4

[1]Fifty-two companies, or eight percent of the respondents, changed auditors.

Reasons for Changing Outside Auditing Firms (51 Companies)

Reason for Change	No. of Mentions
Obtain better performance or service, upgrade to a major firm	17
Reduce auditing fees	10
Belief that change, periodic reappraisal, is desirable	8
Merger, acquisition, reorganization, change of control	4
Change to public ownership from private or mutual status	3
Needs have changed or will change	2
Consolidate audits under one firm	2
Other: Includes conflict of interest, incompatibility, best proposal as a bidder, reorganization of audit firm, get an auditor with more commitment to the company's industry	8
	54[a/]

a/ Greater than 51 because of multiple responses.

Table 20: Corporate Personnel with Reporting Relationships to the Audit Committee, 692 Companies

Position or Title	*Companies in which Personnel Report to Committee*	
	No. of Companies	*Percent*
Chief internal auditor	327	47%
Chief financial officer	46	13
Controller	39	11
Treasurer	9	3
Other member of top management	21	6
Other	8	2

[1]Overall, 353 companies (51 percent) have someone who reports to the committee.

Table 21: Number of Companies in which One or More Executives Have a Formal Reporting Relationship to the Audit Committee, by Industry Category[1]

Industry Category	*No. of Companies*	*Percent of Companies in Category*
Manufacturing	104	39%
Financial	130	73
Nonfinancial service	119	49

[1]Overall, 353 companies (51 percent) of the total sample have one or more such relationship.

Table 22: Number of Companies in which One or More Executives Have a Formal Reporting Relationship to the Audit Committee, by Company Size[1]

Company Size Category	*No. of Companies*	*Percent of Companies in Category*
Under $100 million	23	35%
$100-199	18	35
$200-499	56	51
$500-999	54	48
$1-3 billion	90	60
Over $3 billion	111	57

[1]Overall, 353 companies (51 percent) have one or more such relationship.

Supporting and Verifying the Independence of the Internal Auditing Function

The responsibility of the audit committee to see that the internal audit function has the necessary degree of independence from management interference is spelled out in some committee charters, as these examples illustrate:

"Help ensure the independence, objectivity and effectiveness of the internal audit department by (1) reviewing the appointment of the chief internal auditor and the compliance officer and making recommendations to the chairman and chief executive officer; (2) reviewing and making recommendations regarding Internal Audit's annual plan and schedule; and (3) meeting at least quarterly with appropriate members of the internal audit department to review ongoing audit results."

—A savings bank

"Support the corporation's internal auditors and thereby help assure that they have sufficient independence to conduct their internal audits free of interference or pressure."

—An industrial products company

"Determine that no restrictions are placed on the activities of the independent accountants or the corporate auditing services department in carrying out the audit programs approved by the Audit Committee and annually verify independence of the corporate auditing services department by reviewing their salaries, and by interviewing the manager of corporate audit services."

—An insurance company

Statements Describing Reporting Relationships of Internal Auditors to the Committee

"Corporate internal audit has an independent, functional responsibility to the audit committee of the board of directors for the adequacy and the effectiveness of internal controls. The vice president of corporate internal audit shall meet at least annually with the committee."

—A hotel company

"The auditor shall be directly accountable and subject to the direction of the committee, and the internal auditor's accountability to the committee shall preclude any other organizational relationships which may conflict with the need for independence. For general administrative purposes, the auditor shall report to a member of senior management."

—A bank holding company

"The internal control manager has a reporting relationship to the committee in addition to such reporting relationship as is provided for in the corporation's plan of management organization."

—A packaging materials company

"The Audit Committee shall have direct line, functional responsibilities for the internal audit department, with administrative reporting responsibilities being assumed by the chief executive officer."

—A mortgage and banking company

"The internal auditor shall report directly to the Audit Committee and be administratively responsible to the chief financial officer of the holding company. The auditor cannot be dismissed or hired without the express approval of the Audit Committee."

—A bank holding company

Chapter 5

The Committee's Broader, More Powerful Role

There are clear indications that many audit committees now deal with a broader agenda than 10 years ago and that being a committee member has become more time-consuming. There have also been definite benefits from this trend. For example, many participants contend that the committee has been instrumental in bringing about major improvements in financial controls and auditing and in the quality of financial reporting.

Putting the Committee's Role In Writing

Since 1978 there has been a significant increase in the percentage of companies that have a written description of the audit committee's responsibilities—from 69 percent to 83 percent. The fact that so many committees have had their role reappraised and their job description upgraded since the last report testifies to the committee's increased importance.

Table 23 ranks by frequency of mention the type of documents in which companies spell out their audit committee's role. A board resolution is still the most commonly used document for this purpose, but it has lost some ground since last time. The use of a separate committee charter or mission statement has *gained* ground: 15 percent of companies now report this practice, including 3 percent that also have a more limited statement in the form of a bylaw.

The process of drafting a separate committee charter often results in a detailed description of membership qualifications, areas of responsibility, and degrees of authority delegated for dealing with those responsibilities. Appendix C contains a group of such charters, selected from different

Table 23: Forms of Documents Used to Describe the Duties of the Audit Committee, 524 Companies[1]

Type of Document	*No. of Companies Mentioning*	*Percent[1]*	*1978 Percent[2]*
Board resolution only[3]	265	50%	64%
Bylaw only	85	16	14
Committee charter or job description only	64	12	7[a]
Board resolution[3] **and** document other than bylaw	32	6	5
Board resolution[3] **and** bylaw	13	3	4
Charter **and** bylaw	13	3	2
Proxy statement only	29	6	4
Other documents or combinations	23	4	
Totals		100%	100%

[1]Based on 83 percent of respondents that **have** such a written document.

[2]Based on 69 percent of respondents that **had** such a written document in 1978.

[3]Some board resolutions are comparable to separate charters in scope and detail.

[a]Approximate.

industries, that illustrate how some companies have organized and worded the job descriptions of their audit committees.

More Time Required to Serve on the Committee

As already noted, it takes eight to ten hours a year, on average, for members to prepare for audit committee meetings, and another six hours to attend. Nearly two-thirds of survey respondents also indicated that it takes more time now than 10 years ago and 74 percent contend it will require more time in the future. Among the reasons given for why audit committee service takes more time now were:

	No. of Mentions
Increase in committee's responsibilities, oversight requirements	13
Complexity of issues considered, of doing business	7
Greater general awareness of the audit committee's function and importance	4
Increase in litigation, exposure to foreign legal standards	4
Increase in, or complexity of, accounting trends and regulations	3
Expansion of internal audit function	1
Increased exposure of directors to lawsuits	1
Compliance with Foreign Corrupt Practices Act	1
Increased social and moral awareness	1

Among the reasons cited for why audit committee service will take more time in the future were:

	No. of Mentions
Increase in the committee's responsibilities; oversight requirements, need to ask more insightful questions	9
Complexities of issues, of doing business will increase	7
Treadway Commission recommendations, FASB requirements will have an effect	5
General trend toward more oversight and improved corporate governance will continue	5
Litigation (and concerns about it) will increase	4
Government regulation and legislation affecting areas of responsibility of audit committees will increase	4
Trend to assign more board responsibilities to committees will continue	1

Expanding Beyond Financial Reporting and Controls

More audit committees are now involved in matters outside the traditional scope of this committee's concerns. The basic focus of audit committees has been, and still is, the annual audit process and the dependability of year-end audited financial statements. In recent years, monitoring internal controls has been singled out for emphasis within this basic responsibility, partly in response to the Foreign Corrupt Practices Act enacted in 1977. No doubt this trend has added to the time requirements of audit committee service, but it is within the scope of the traditional role of the committee.

Of increasing importance is the assortment of assignments that expand the committee's responsibilities into different areas and that require different approaches to monitoring and reviewing. One that is closely related to the committee's core duties, but with an important difference, is the review of quarterly financial statements. These are not audited by the outside accounting firm.

The Treadway Commission recommended that: "Audit committees should review the quarterly reporting process," and made the following comment:

> "The audit committee's oversight responsibilities undertaken on behalf of the board of directors extend to the quarterly reporting process. The audit committee should review the controls that management has established to protect the integrity of the quarterly reporting process ... If actual financial results for a quarter vary significantly from budgeted or projected results previously disclosed to the directors, management should advise the board or the audit committee before the actual financial results are released to the public. Management should also inform the board or the audit committee in advance of any proposed changes in accounting or financial reporting practices and of any other unusual events that could have a significant impact on the financial statements."

As noted in Chapter 1, this phrasing marks a retreat from the initial draft of the report, which had proposed that the audit committee approve the quarterly statements. It also appears to place on management much of the responsibility for bringing certain matters to the committee's attention. But there has been resistance to the idea of requiring the committee to cope with figures that lack the discipline of the audit process. And there is concern that the committee's involvement might suggest a "hardness" to quarterly figures that does not exist but could mislead investors, thus creating the possibility of litigation. From management's point of view, the committee's involvement in quarterly financial statements is largely open to question or considered inappropriate (see Table 1). And very few of the charters submitted by respondents make any mention of quarterly statements (see box on p. 25 for exceptions.)

Most of the tasks that stretch the committee's reach beyond financial issues relate to monitoring corporate behavior, both the firm's as a whole and on the part of individual ex-

ecutives or other employees (or directors). Thus, many audit committees now oversee the content of, and compliance with, corporate policies governing ethical behavior and employee conflict of interest. Some committees also monitor compliance with specified laws such as the Foreign Corrupt Practices Act, or with the Defense Industry Initiatives (a set of principles, policies and procedures developed voluntarily by a group of companies that are suppliers to the Federal government's defense program). Some have an even broader mandate and monitor the company's compliance with the law in general; this may include reviewing litigation against the company or its employees or directors. A manufacturing company sums up some of these responsibilities as follows: [The audit committee should] "monitor compliance with the company's conflict of interest and business policies and review major claims or litigation pending against the company."

Typically, carrying out these additional nonfinancial responsibilities involves communicating with corporate personnel, such as the general counsel or a compliance officer. Broadening the committee's list of concerns calls for different procedures and the ability to ask a new line of probing questions.

A final point on the audit committee's enlarged role: This committee is sometimes the logical choice when a situation arises that requires investigation or review at the board level but does not fit easily into the job description of any particular board committee. Several of the audit committee's characteristics recommend it: (1) it is made up of outside directors, which gives it objectivity; (2) it is accustomed to probing; and (3) it has experience working with outside accounting firms.

Involving the Audit Committee with Quarterly Earnings and Financial Statements

A few charters define a role for the committee regarding unaudited quarterly statements. This role varies from one company to the next, as these excerpts illustrate:

"The committee will review and approve where appropriate the following reports of the independent auditors: (1) Reports on the limited review of unaudited quarterly financial statements."

—A bank holding company

"Participation in the financial reviews preceding the annual and quarterly reports to stockholders, where possible as a committee and otherwise through representation by as many committee members as possible."

—An electronics company

"The Audit Committee will review with senior management the annual stockholders report and each quarterly report prior to publication."

—A savings bank

"Review the company's quarterly earnings, including the impact of unusual items and changes in accounting principles and estimates."

—An energy company

Committee Authority

The true significance of delegating responsibility to a board committee depends on whether that committee has the necessary authority to carry out its assignments. This study did not attempt to quantitatively assess whether today's audit committees have increased authority or power commensurate with their enlarged list of tasks. It adds to the evidence, however, that audit committees now have considerable authority.

For example, an examination of current committee charters suggests that there have been moves to strengthen the audit committee's authority: by stating explicitly that specific matters are within the committee's scope of responsibility, and by using language, where appropriate, that empowers the committee to act or decide. Thus, charters are more detailed and tend to spell out more assignments than they used to; this clarifies, if nothing else, the right of the committee to be involved in overseeing specific areas. But charters also use words such as "approve," or the committee is "granted the authority" to act (in the case of investigations, to "direct and supervise"). And some charters specify that the committee may hire outside expert assistance if necessary.

A better measure of the extent of authority granted to the committee appears in Table 24, which shows that:

- For every activity listed, at least a majority of the surveyed committees are authorized to deal with it (the figure goes as high as 98 percent for private meetings with outside auditors);
- Authority is an unwritten presumption at least as often as it is a written power; and
- A majority of committees are authorized to play a role in various activities outside the traditional, strictly financial ones.

The power to initiate an investigation into questionable or suspicious developments—the third item in Table 24—is one that gives the committee a great deal of potential for independent action. Among the respondent companies, 16 percent (107 companies) reported that their audit committee had conducted such an inquiry. The box on page 26 lists some of the situations looked into by these committees; the list is long and varied and verifies that audit committees have a broad mandate and a strong hand.

Table 25 shows that independent inquiries by the audit committee are somewhat more likely in large companies.

Opinions on Broadening and Strengthening the Committee's Role

This report supports the conclusion that the trend toward expanding the purview of the audit committee and giving

it more clout has broad support. However, beginning with the selected Treadway Commission recommendations in Chapter 1, the findings also suggest that a significant number of people question the appropriateness of some elements of that trend or of concepts being proposed in connection with it.

Respondents to the chief executive/chief financial officer survey were asked to indicate which of three statements comes closest to expressing their overall opinion concerning this trend. Their answers point up the differences of opinion that exist:

A Broadened Role for Audit Committees:	Percent of Respondents
Should be generally encouraged in the interest of sounder corporate governance	37%
Is worthwhile for many companies but not necessarily appropriate for all audit committees or all corporate circumstances	39
Should be limited to situations where there is a special oversight need	24
	100%

Base: 121 companies

Most comments received in explanation of these choices were from respondents with reservations or definite objections to the trend. Mentioned most often was the concern that a powerful, far-ranging audit committee would threaten to compromise the important difference between oversight and managing. Other problems or cautions included the following:

- Some items being entrusted to audit committees are more appropriate for other committees, such as a public policy committee, or should be a concern of the full board;
- It puts too much of a time burden on members of the committee;
- It is not appropriate to place so much more responsibility on the members of this committee than on other board members (in reference to nonfinancial matters);
- Making the audit committee responsible for these matters lessens the accountability of management for them, which is where it really belongs.

It is worth mentioning that those on the side of keeping the audit committee focused on its traditional role included influential members of the accounting profession. Outside auditors value the committee's contribution to improving the audit process and see it as a guarantor of independence. Some accountants argue that a broadened role for the committee might dilute its effectiveness. This position was well expressed recently by the chairman and chief executive of Peat Marwick Main & Co. (see the box on p. 27).

Allegations or Situations Investigated by Audit Committees of Survey Respondents

Payments in violation of the Foreign Corrupt Practices Act.
Defalcation, embezzlement, misuse of corporate assets.
Investigations by SEC or other government agencies or bureaus.
Insider trading violations.
Inventory irregularities.
EDP security problems.
Conflicts of interest.
Kickback payments.
Litigation.
Political payments.
Illegal conduct by a subsidiary firm.
Inadequate financial controls at a subsidiary firm.
Internal complaint against management.
Environmental compliance audit.
Fairness of proposal to go private.

Table 24: Authority of Audit Committees to Carry Out Various Activities, 689 Companies

	Percent of Committees Reporting Each Degree of Authority				
Audit Committee Activity	*Has Written Authority*	*Has Presumed Authority (Unwritten)*	***Total With Authority***	*Presumed to Have No Authority*	*Authority Not Established*
Meet privately with outside auditors	26%	72%	**98%**	1%	2%
Meet privately with internal auditors	21	72	**93**	1	6
Initiate investigations	17	69	**86**	1	13
Monitor compliance with Foreign Corrupt Practices Act	20	59	**79**	6	15
Monitor conflict-of-interest policy	25	51	**76**	8	15
Monitor code of ethics or behavior	24	50	**74**	8	18
Monitor compliance generally with laws or regulations	18	54	**72**	8	20
Review quarterly financial statements	20	48	**68**	12	20
Monitor Racketeer Influenced and Corrupt Organizations Act (RICO)	8	56	**64**	8	29
Hire outside expert advice or service	12	49	**61**	8	31

Table 25: Number of Companies Whose Audit Committee Has Initiated an Investigation, by Company Size[1]

Company Size Category	*No. of Companies*	*Percent of Companies in Category*
Under $100 million	4	6%
$100-199	7	14
$200-499	14	13
$500-999	18	16
$1-3 billion	26	18
Over $3 billion	38	20

[1]Overall, 107 companies, (16 percent) reported that their audit committee has initiated an investigation.

An Accounting Firm Cautions Against Complicating the Committee's Role

Commenting on the trend to expand the responsibilities of audit committees, Larry D. Horner, Chairman and Chief Executive of Peat Marwick Main & Co., noted:[1]

At Peat Marwick our position is clear: anything that impairs an audit committee's ability to be independent is a threat to good governance. On the other hand, we believe that it should be up to each board to see where the line between oversight and management is drawn.

Evolving Role

For almost 40 years audit committees have been in existence. In that time their growth has been accompanied by an evolution of their responsibilities or functions. Today, the goal is improved corporate accountability. At Peat Marwick we believe that there are certain oversight functions common to all audit committees:

- To oversee the company's internal accounting controls; this helps insure sound financial reports and good stewardship of corporate assets;
- To review the internal audit department;
- To participate in the selection of independent auditors;
- To review the annual audit plan with the independent auditor;
- To review the annual report and the results of the independent audit.

Discretionary Powers

What the audit committee decides to take on as its role beyond these five functions is discretionary. After all, what might be appropriate for the audit committee of General Electric or General Motors may not be appropriate for an emerging growth company. This decision depends on the board's sense of its corporate needs and its understanding of the company's operating environment. Yet diverse roles can strain a committee's resources and its effectiveness.

More importantly, a committee should not take on functions that involve it too directly in operational matters. This will impair the committee's independence and credibility can suffer.

For this reason, Peat Marwick opposes any mandate or movement that would detract from the audit committee's oversight of auditing and financial reporting.

This is clearly the committee's primary role and it is how the committee contributes to accountability.

[1] From an address at the Annual Meeting of the National Association of Corporate Directors, October 20, 1987, quoted in *Director's Monthly*, March, 1988.

Supporters of an expanded role for the committee include a chief executive whose audit committee already practices many of the Treadway Commission recommendations, and another who believes that the Treadway "good practice guidelines" (see Appendix A) should apply to all corporate entities. One chief executive stressed that, provided it does not make the mistake of trying to manage, the committee's interest in a broad range of issues could enhance the board's understanding of them.

Changes Attributable to Audit Committees

Table 26 provides the survey's best evidence of the important role the audit committee has played since gaining prominence in the 1970s. Included in the questionnaire to chief executives and chief financial officers was a list of items—activities and areas of concern—with which the committee is involved. Respondents indicated whether they believe that the work of the committees has brought about any improvement in these activities over the past ten years and whether the committees have improved the awareness and effectiveness of boards of directors regarding these activities.

The results show that, in the opinion of these survey respondents, the audit committee has had a very beneficial impact on both how well key functions in the financial area are performed and how effectively boards of directors can oversee those functions. Some of the more significant findings from the table are:

- The committee has been especially effective in bringing about improvements in procedures or practices—how things are done.
- Internal auditing has benefited most from the audit committee's oversight, both in its procedures and in the effectiveness of its work. It is the item that was rated highest as having experienced *major* improvement.
- Financial controls have been strengthened in a majority of companies, both in procedures and in reliability.
- Boards of directors have a much better handle on monitoring the financial integrity of their firms.

Even though these figures are based on a sample that is too small to support a claim of statistical significance, they suggest audit committees have made a real difference for the better. And both corporate managements and boards of directors have been the beneficiaries, along with investors and others who rely on dependable corporate disclosures.

The Question of Enhanced Liability

Does adding responsibility to audit committees also add extra exposure to liability for committee members? The chief executives and chief financial officers were asked whether they were concerned that directors serving on audit committees might be deemed to have a special responsibility or knowledge that would increase the likelihood of their being sued. Three-fourths agreed that enhanced liability is a possibility. But most of this concerned majority also said they believe that corporate indemnification, insurance coverage, and state statutory protection—as they are evolving—will be sufficient to offset the additional exposure.

Table 26: Extent to which Audit Committees Have Improved Specific Activities Over the Past Ten Years, As Indicated by 121 Chief Executives and Chief Financial Officers

	Percent of Respondents Indicating Each Change			
Activity and Nature of Change	*Major Change*	*Some Change*	*Total Indicating Change*	*Little or No Change*
A. Improving **procedures or practices** followed in:[1]				
Internal auditing	27%	60%	87%	13%
Monitoring	14	68	82	18
Financial controls	11	61	72	28
The external audit	6	49	55	45
Computer security	6	48	54	46
Financial reporting	1	53	54	46
Ensuring corporate compliance with legal requirements or constraints	10	42	52	48
B. Improving the **effectiveness** (or thoroughness or reliability) of:[1]				
Internal auditing	21%	60%	81%	19%
Monitoring	11	61	72	28
Financial controls	8	56	64	36
Ensuring corporate compliance with legal requirements or constraints	10	41	51	49
The external audit	4	47	51	49
Financial reporting	3	45	48	52
Computer security	5	42	47	53
C. Improving the **board's**:				
Understanding and timely awareness of the above activities	15%	69%	84%	16%
Effectiveness in fulfilling its responsibilities in connection with these activities	14	65	79	21

[1]Ranked by percentage of respondents indicating at least some change.

Appendices

Appendix A

Good Practice Guidelines for the Audit Committee

From Report of the National Commission on Fraudulent Financial Reporting ("Treadway Commission"), October, 1987

Introduction

Primary responsibility for the company's financial reporting lies with top management, overseen by the board of directors. To help boards of directors carry out this oversight responsibility, the Commission recommends that all public companies establish audit committees consisting of independent directors. Establishment of such committees, of course, does not relieve the other directors of their responsibility with respect to the financial reporting process. The Commission therefore reinforces its general recommendation with more specific recommendations for audit committee duties and responsibilities.

First, specific recommendations directed to audit committees highlight the need for the audit committee (1) to be informed and vigilant, (2) to have its duties and responsibilities set forth in a written charter, and (3) to be given resources and authority adequate to discharge its responsibilities. Among other things, the audit committee should review management's evaluation of factors related to the independence of the company's public accountant, help preserve that independence and review management's plans for engaging the company's independent public accountant to perform management advisory services during the coming year, considering the types of services that may be rendered and the amount budgeted for such services.

In addition, the Commission highlights other important audit committee functions ... The audit committee should review the company's process of assessing the risk of fraudulent financial reporting and the program that management establishes to monitor compliance with the code of corporate conduct. The audit committee should have open lines of communication with the chief accounting officer and the chief internal auditor. In fact, the chief internal auditor's direct and unrestricted access to the audit committee is vital to his objectivity. Management should advise the audit committee when it seeks a second opinion on a significant accounting issue. Audit committees should oversee the quarterly reporting process. Finally, the chairman of the audit committee should write a letter describing the committee's activities and responsibilities for inclusion in the annual report to stockholders.

The Commission developed this set of recommended audit committee duties and responsibilities from a review and consideration of the practices many well-managed companies follow today, of the extensive guidance the public accounting and legal professions have published on the subject, and of practices suggested by the results of the Commission's research projects, and by presentations made to the Commission.

The Commission believes that more detailed delineation and description of responsibilities is best left to the discretion of management and the board of directors to tailor to the needs and circumstances of each company. In the course of its research and deliberations, however, the Commission has identified additional, more specific practices and procedures that can help audit committees perform their oversight role effectively. The Commission is not prescribing these additional measures, and therefore has not included them as recommendations, but offers this guidance in the form of the following Good Practice Guidelines, which companies can consider within the exercise of their judgment. To companies that already have audit committees, the guidelines will serve as a standard for review and assessment. Other companies—those just establishing audit committees or those seeking to improve their committees' effectiveness—may find them to be helpful in suggesting practical ways for audit committees to discharge their responsibilities.

General Guidelines

Size and Term of Appointment: An audit committee normally should consist of not fewer than three independent directors. The maximum size may vary, but the committee should be small enough so that each member is an active par-

ticipant. The term of appointment is at the discretion of the board of directors, but it is desirable to have terms arranged to maintain continuity while bringing fresh perspectives to the work of the committee.

Meetings: The committee should meet on a regular basis and special meetings should be called as circumstances require. The committee should meet privately with the internal auditor and the independent public accountant.

Reporting to the Board of Directors: The committee should report its activities to the full board on a regular basis, such as after each meeting, so that the board is kept informed of its activities on a current basis.

Expand Knowledge of Company Operations: A systematic and continuing learning process for audit committee members will increase their effectiveness. One way is to review various financial aspects of the company on a planned basis.

Company Counsel: The committee should meet regularly with the company's general counsel, and outside counsel when appropriate, to discuss legal matters that may have a significant impact on the company's financial statements. In a number of companies the general counsel and/or outside counsel attend meetings.

Audit Plans: The committee should review with the chief internal auditor and the independent public accountant their annual audit plans, including the degree of coordination of the respective plans. The committee should inquire as to the extent to which the planned audit scope can be relied upon to detect fraud or weaknesses in internal controls.

Electronic Data Processing: The committee should discuss with the internal auditor and the independent public accountant what steps are planned for a review of the company's electronic data processing procedures and controls, and inquire as to the specific security programs to protect against computer fraud or misuse from both within and outside the company.

Other Auditors: The committee should inquire as to the extent to which independent public accountants other than the principal auditor are to be used and understand the rationale for using them. The committee should request that their work be coordinated and that an appropriate review of their work be performed by the principal auditor.

Officer Expenses and Perquisites: The committee should review in-house policies and procedures for regular review of officers' expenses and perquisites, including any use of corporate assets, inquire as to the results of the review, and, if appropriate, review a summarization of the expenses and perquisites of the period under review.

Areas Requiring Special Attention: The committee should instruct the independent public accountant and the internal auditor that the committee expects to be advised if there are any areas that require its special attention.

Selection of an Independent Public Accountant

A primary responsibility of the audit committee should be the selection of an independent public accountant for the company. The actual selection generally is proposed by management, with the audit committee confirming management's selection, and is ratified by the stockholders. Suggested below are a number of considerations that may enter into the decision. There will be variations, of course, including those that depend upon whether the committee is considering management's proposal to retain the present independent public accountants or management's proposal to appoint a new public accounting firm.

Issues related to this audit

- Opinions on the performance of the public accounting firm by appropriate management and the chief internal auditor;
- The proposed audit fee and the independent public accountant's engagement letter; explanations for fee changes;
- The expected level of participation by the partner and other management personnel in the audit examination, the mix of skills and experience of the staff, and staff rotation policy;
- If a new public accounting firm is being considered, the steps planned to ensure a smooth and effective transition.

Issues related to the firm generally

- The report of the public accounting firm's latest peer review conducted pursuant to a professional quality control program;
- Any significant litigation problems or disciplinary actions by the SEC or others;
- The public accounting firm's credentials, capabilities, and reputation and a list of clients in the same industry and geographical area.

Post-Audit Review

- The committee should obtain from management explanations for all significant variances in the financial statements between years. (This review may be performed at a meeting of the entire board.) The committee should consider whether the data are consistent with the Management's Discussion and Analysis (MD&A) section of the annual report.
- The committee should request an explanation from financial management and the independent public accountant of changes in accounting standards or rules promulgated by the Financial Accounting Standards Board, Securities and Exchange Commission or other regulatory bodies, that have an effect on the financial statements.
- The committee should require about the existence and substance of any significant accounting accruals, reserves, or estimates made by management that had a material impact on the financial statements.
- The committee should require of management and the

independent public accountants if there were any significant financial reporting issues discussed during the accounting period and if so how they were resolved.

- The committee should meet privately with the independent public accountant, to request his opinion on various matters including the quality of financial and accounting personnel and the internal audit staff.
- The committee should ask the independent public accountant what his greatest concerns were and if he believes anything else should be discussed with the committee that has not been raised or covered elsewhere.
- The committee should review the letter of management representations given to the independent public accountant and inquire whether he encountered any difficulties in obtaining the letter or any specific representations therein.
- The committee should discuss with management and the independent public accountant the substance of any significant issues raised by in-house and outside counsel concerning litigation, contingencies, claims or assessments. The committee should understand how such matters are reflected in the company's financial statements.
- The committee should determine the open years on federal income tax returns and whether there are any significant items that have been or might be disputed by the IRS, and inquire as to the status of the related tax reserves.
- The committee should review with management the MD&A section of the annual report and ask the extent to which the independent public accountant reviewed the MD&A section. The committee should inquire of the independent public accountant if the other sections of the annual report to stockholders are consistent with the information reflected in the financial statements.
- The committee and the board of directors should consider whether the independent public accountant should meet with the full board to discuss any matters relative to the financial statements and to answer any questions that other directors may have.

Appendix B

Examples of Preplanned Agendas for Audit Committee Meetings

Petroleum and Gas Company

Agenda Items	*First Meeting*	*Second Meeting*	*Third Meeting*
	February	*May/June*	*September/ October*
Approve minutes of prior meeting	X	X	X
Review financial statements, footnotes, adjustments, accounting changes	X		
Review management letter-comments	X		
Review management letter-responses	X		
Review audit fees	X		
Review non-audit services, auditor independence	X	X	X
Review internal audit activities	X	X	X
Review related party transactions	X		
Review executives' perquisites	X		
Review outstanding litigation involving CPA's or officers, directors or stockholders	X	X	X
With general counsel, review responses to questionnaire on business ethics, conflicts of interest	X		
Review quality & depth of staffing in accounting, finance, and internal audit departments	X		
Review internal audit programs	X		
Review CPA's planned audit scope	X		
Approve engagement of independent certified public accountants	X		
Review adequacy of internal accounting controls	X		
Other matters	X	X	X

Manufacturing Company

Schedule of Regular Reports to the Audit Committee

January:

- Review of third quarter Form 10-Q
- Procedures for preparation of proxy materials
- Personal use of corporate facilities by officers and directors
- Review of non-audit services performed by independent auditors (resolution)
- Evaluation of professional qualifications and independence of independent auditors
- Report on external audit costs
- Recommendation for appointment of independent auditors (resolution)

February:

- Report on conduct of internal audits

- Report on conduct of independent audit
- Review of accounting policies and outside developments
- Review of annual report (resolution)
- Report on independent auditors' Certification Letter and Internal Accounting Control Letters
- Procedures for preparation of the annual Form 10-K
- Review of annual Form 10-K (resolution)

June:

- Review of internal accounting controls (FCPA documentation)
- Review of first quarter Form 10-Q
- Plan and scope for internal audits
- Plan and scope for independent auditors' audit
- Review of officers' and directors' expense reports

September:

- Report on Managemen. Letter and audit comments
- Review of second quarter Form 10-K
- Report on organization of the control function
- Report on information security
- Review of recent changes in accounting standards

Bank

February meeting (combined meeting with Loan Review and Examining Committee):

- Review of independent audit results for prior year, including significant financial issues and any audit matter pertaining to company and subsidiaries;

Manufacturing Company

Standard Agenda Items and Regular Meetings

Standard Agenda Items	*Regular Meetings*			
	Jan.	*Mar.*	*June*	*Sept. or Oct.*
1. Discussion with outside auditors of prior year audit	X			
2. Review draft of financial statements to be included in annual report	X			
3. Review performance of outside auditors including fees and charges	X			
4. Executive sessions w/outside auditors; w/management; w/Director, Internal Audit	X			
5. Recommend outside auditors for forthcoming year	X			
6. Review non-audit services provided by outside auditors and non-audit services planned by management for forthcoming year	X			
7. Review internal audit plan for forthcoming year	X			
8. Review outside auditors' "no material weakness" letter		X		
9. Annual report on internal audit activities per previous year		X		
10. Report by Corporate Director of Security		X		
11. Approval of Chairman's and CEO's expenses		X		X
12. Discussion w/outside auditors on plans for forthcoming audit			X	
13. Report by Director, Internal Audit on the code of business conduct certification from officers and key employees			X	
14. Report by Director, Internal Audit, on compliance w/Foreign Corrupt Practices Act (anti-bribery provisions)			X	
15. Outside auditor's current year audit plan				X
16. Update on internal audit activities	X	X	X	X
17. Review standard agenda items and meeting dates for following-year				X
18. Legal update on pending litigation	X	X	X	X
19. Provision for special reports by management/internal auditor		X	X	

- Review year-end fiscal financial statements and footnotes;
- Recommendation for selection of auditors for the current year;
- Review of general auditor's opinion of internal controls;
- Review of compliance with corporate code of ethics

May Meeting:

- Review of independent auditor's management letter and management's response;
- Review general auditor's fourth and first quarter reports;
- Review Corporate Compliance Department's activities

November Meeting:

- Review general auditor's second and third quarter reports;
- Review next year's internal audit scope and plan;
- Review Corporate Compliance Department's activities

Diversified Utility Company

The principle business of such meetings shall be:

(a) Regular winter meeting (prior to public release of financial statements certified by independent public accountants):

(1) Review of results for previous year by chief financial officer.
(2) Explanation of significant changes from preceding year.
(3) Adequacy of disclosure of significant items.
(4) Effect on statements of any changes in accounting policies initiated by the company, by the independent public accountants, or prompted by pronouncements of standard boards or governmental authorities.
(5) Status of audits and conclusions therefrom by independent public accountants and by internal auditors.
(6) Presentation of financial statements.
(7) Report on any illegal, improper or sensitive payments.
(8) The committee chairman will review, or cause to be reviewed, the expense account of the preceding year of the chief executive officer and the manifests of any airplanes owned or chartered by the company.

(b) Regular spring meeting:

(1) The Director of Internal Audit will issue a written report to the committee on the results of the internal audit department's prior year's audit activities. This report should include the most significant recommendations to management for improvements in accounting systems and controls, with a summary, if appropriate.
(2) The Director of Internal Audit will submit a schedule of the coming year's audit plans.
(3) The independent public accountants will issue to the committee their letter or letters of recommendation to management for improvements in accounting systems and controls, with summary, if appropriate, of most significant items.
(4) The independent public accountants and the Director of Internal Audit will report on significant recommendations from prior years which have not been put into effect.
(5) Management will report on action taken or proposed to be taken in response to No. 3 and No. 4 above, with reasons.
(6) Review of report of Director of Internal Audit on prior year's audit (see above).

(c) Regular fall meeting:

(1) Review of proposed audit objectives and plan for current year by independent public accountants.
(2) Report by the chief financial officer of the fees of the independent public accountants for audit of preceding year and anticipated in current year, with comparison with prior years and, if possible, with other similar companies. However, the responsibility for and the negotiation of the fees of the independent public accountants is wholly the province of management.
(3) Discussion between Director of Internal Audit and committee of competence of, and relationship with, the independent public accountants.
(4) Report by chief financial officer and/or controller to committee of competence of, and relationship with, the independent public accountants and his recommendation on their retention or replacement.
(5) Discussion and decision by committee, meeting alone, on its recommendation to the board on the independent public accountants to be retained for next fiscal year.
(6) Discussion between the independent public accountants and committee, with no company employees present, of the competence and cooperation of company accounting and auditing officers and staff, and of the basic soundness of their policies and practices.

Energy Company

The committee will meet a minimum of three times a year with more meetings scheduled as the committee deems advisable. The three regular meetings are:

1. February: Meet with the independent auditors, review the final audit, and receive recommendations and exceptions based on results of the annual audit. From the appropriate company personnel and the independent auditors, the committee will require any information about deviations from

established codes of conduct within the company. The committee will meet with the company's management to discuss with them the scope of internal accounting and financial controls then in effect, the extent to which recommendations made by the independent accountants have been implemented, and any other comments they may make.

2. July: Meet with the independent auditors to review and discuss the management letter, set the scope of the audit, and approve audit fees. In addition, the committee will meet with the internal auditors of the company to review the scope of their work for the year. This review may also include a personnel review.

3. October: Discussions will be held with both the independent auditors and the internal auditors as to the success of the last audit and any recommended changes in procedure. The committee will review the corporate insurance program and other programs for the protection, control or security of corporate assets or facilities.

Bank Holding Company/Subsidiary Bank

The Audit Committee is expected to carry out its duties as follows:

January Meeting:

1. Recommend the particular firms to be employed by the corporation as its independent auditors.
2. Review with management and the independent auditors the preliminary financial statements of the corporation, selected accounting issues and year end financial press release.

February Meeting:

1. Review with management and the independent auditors the annual financial statements of the corporation prior to their approval by the board for publication and report to the board thereon.
2. Review, in consultation with the independent auditors and the internal auditors, the adequacy of systems of internal controls and compliance therewith.
3. Review with the internal auditors the Trust Department's compliance with law, Regulation 12 CFR 9, and sound fiduciary principles.
4. Review the internal auditor's plan of audit and approve its operating budget.
5. Evaluate the independence and performance of the internal auditor.

May Meeting:

1. Review the follow-up of management to recommendations of examiners and the independent and internal auditors.
2. Review the conflicts of interest policies of the corporation, including the formulation of recommendations to the board on any specific matter on which the board will act and review the reports required to be made to the board under the provisions of the conflicts of interest policy.
3. Monitor and recommend to the board policies and procedures to be followed regarding the obligation of the corporation and bank to indemnify directors and officers and review and make recommendations with regard to requests for indemnification.

September Meeting:

1. Special presentations as requested by committee covering risks and attendant controls for specified activities and functions.

November Meeting:

1. Consult with the firms chosen to be the independent auditors and review their audit plans.
2. Review annually the fees charged by the independent auditors for the work performed by them in the preparation of their reports.

Ongoing and Timely:

1. Provide an avenue of communication between the independent and internal auditors and the board of directors.
2. Review all significant accounting issues (including any changes in accounting principles) with management and the independent auditors prior to any decisions being reached on reporting practices to be followed by the corporation and the bank and report thereon to the board.
3. Review with the corporation's general counsel releases of the Securities and Exchange Commission, regulations of the New York Stock Exchange and any other pertinent regulations affecting the corporation's financial statements.
4. Recommend to management the presentation of additional information helpful to the directors in their understanding of corporation and bank operations and finances.
5. Review the examination reports and recommendations of the Federal Reserve and the Comptroller of the Currency.
6. Review and make recommendations with regard to requests for indemnification.
7. Review reported conflicts of interests and make recommendations to board where required.

Bank Holding Company/Subsidiary Bank

January Meeting:

1. **Recurring Items**: The following items will normally be included on the agenda of every regularly scheduled meeting with the intention being that the status of these items being reported will be updated from the time of

the previous meeting. Of course, if these items are inappropriate for a specific meeting, they need not be included.

a. Report by internal auditor as to specific audit work assignments completed and a comparison of work completed to work scheduled. Audit work in the Trust area will be specifically commented upon, when appropriate, and once each year a report will be made as to whether the Trust Department is being administered in accordance with the law, 12 CFR 9 and sound fiduciary principles. This will be included in the committee minutes and reported to the board.
b. Summary by internal auditor as to the coordination of the audit program with work assignments by independent public accountants.
c. Summary by internal auditor of work completed by credit review officers with comments as to apparent effectiveness of such credit review work.
d. Report by internal auditor as to exceptions noted but not accepted by the responsible managers, or changes not made within a reasonable time, i.e., items reported previously and repeated in current audits.
e. Report of internal auditor of reported shortages and defalcations.
f. Comments by principal accounting officer as to progress of audit work by independent public accountants, noting any delays encountered or other problems that may result in an overrun of estimated fees.
g. Review by principal accounting officer of management letters issued by independent public accountants and resultant action taken by management.

2. **Financial Reporting**: Review by principal accounting officer of any major accounting or reporting changes to be made for year-end reports. If significant problems are expected because of the changes or if any proposed audit accounting adjustments have been proposed by the independent public accountants, their representative should participate in this portion of the meeting. The principal accounting officer should obtain the concurrence of the independent public accountants as to their evaluation of major changes. This report should discuss whether accounting principles and policies being used compare favorably with those generally used in the bank holding company field, and whether these matters meet the requirements of laws, regulations and requirements of regulatory bodies having jurisdiction over the Corporation.
3. **Audit Schedule**: Presentation by auditor of complete summary of work completed in prior year and work to be undertaken in current year. Coordination with independent public accountants should be noted. Committee should approve this schedule. At this time, auditor should discuss staffing and estimating costs of his department.
4. **Other Matters**: As appropriate.

April or May Meeting:

1. **Recurring Items**: Same as outlined above.
2. **Fee Status**: Report by principal accounting officer and by representatives of accounting firm as to fees of independent public accountants in past year as well as estimate for current year. Changes in scope of work should be highlighted. Any work not originally contemplated, but undertaken by the independent public accountants during the past year should be specifically noted. The committee should approve the estimate fee.
3. **Report of Independent Accountants**: Meeting of the committee, in executive session, as considered appropriate with representatives of accounting firm, specifically covering:
   a. Significant items resulting from their audit of the past year.
   b. Audit exceptions not satisfactorily resolved with management during the course of the audit of the past year or prior years.
   c. Limitations encountered in performing audit work, any lack of cooperation from management.
   d. The adequacy of the corporation's financial reporting practices, adequacy of internal controls, any deviations from accounting principles and policies being generally used by bank holding companies, and any variances from laws, regulations and requirements of the appropriate regulatory agencies.
   e. An evaluation of the internal audit program and work, specifically with respect to:
      1) The quality of work performed by the internal audit staff.
      2) The quantity of work performed, both as to the ideal situation and the actual situation that existed during the past year—the efficiency of the staff.
      3) The adequacy of the internal audit staff, both as to the number of staff members and the qualifications and training of the staff.
      4) The effectiveness of the internal audit staff, direction, objectivity, management support.
      5) The adequacy of bank directors' examinations, the apparent adequacy of follow-up by officers.
4. **Engagement of Independent Accountants**: Discussion leading to committee recommendation to the full board as to selection of independent public accountants for the current year's examination.
5. **Other Matters**: As appropriate.

October Meeting:

1. **Recurring Items**: Same as outlined above.
2. **Insurance Coverage**: Presentation by risk management department representative as to insurance coverages in general and blanket bond in particular.
3. **Computer and Data Security Report**: Presentation by manager of data processing on physical and data security.
4. **Other Matters**: As appropriate.

Appendix C

Statements of Duties and Procedures of the & Audit Committee

The following audit committee charters or statements of function were among the most complete and explicit of those provided by cooperators in this report. Excerpts from many such statements are found throughout the body of the text.

An Energy Company

The board of directors hereby constitutes and establishes an audit committee with authority, responsibility, and specific duties as described below.

Composition

The committee shall be comprised of three directors who are independent of management and operating executives. Their terms shall be staggered so that the committee annually includes a new member, and members with one and two years of service. One of the members shall be appointed committee chairman by the chairman of the board of directors.

Authority

The audit committee is granted the authority to perform each of the specific duties enumerated in this committee charter and, upon the direction and approval of the board of directors, to investigate any activity of the company; however, the chairman of the board of directors may, from time to time, appoint a select committee of independent directors to make specific investigation. All employees are directed to cooperate as requested by members of the committee. The committee is empowered to retain persons having special competence as necessary to assist the committee in fulfilling its responsibility. However, the committee will notify the board of directors of such action and, if appropriate, receive board approval before proceeding.

Responsibility

The audit committee is to serve as a focal point for communication between noncommittee directors, the independent accountants, internal audit, and corporate management, as their duties relate to financial accounting, reporting, and controls. The audit committee is to assist the board of directors in fulfilling its fiduciary responsibilities as to accounting policies and reporting practices of the company and all subsidiaries and the sufficiency of auditing relative thereto. It is to be the board's principal agent in assuring the independence of the corporation's independent accountants, the integrity of management, and the adequacy of disclosures to stockholders. The opportunity for the independent accountants to meet with the entire board as needed is not be to be restricted, however.

Meetings

The audit committee is to meet at least three times per year, and as many times as that committee deems necessary.

Attendance

Members of the audit committee are to be present at all meetings. As necessary or desirable, the chairman may request that members of management, the director of internal audit, and representatives of the independent accountants be present at meetings of the committee.

Minutes

Minutes of each meeting are to be prepared and sent to committee members and to directors who are not members of the committee. If the secretary of the corporation has not taken the minutes, they should be sent to him or her for permanent filing.

Specific Duties

The audit committee is to

1. Inform the independent accountants and management that the independent accountants and the committee may communicate with each other at all times; and the committee chairman may call a meeting whenever he deems it necessary.
2. Review with the company's management, independent accountants, and director of internal audit, the company's general policies and procedures to reasonably assure the ade-

quacy of internal accounting and financial reporting controls.

3. Have familiarity, through the individual efforts of its members, with the accounting and reporting principles and practices applied by the company in preparing its financial statements. Further, the committee is to make, or cause to be made, all necessary inquiries of management and the independent accountants concerning established standards of corporate conduct and performance, and deviations therefrom.
4. Review, prior to the annual audit, the scope and general extent of the independent accountants' audit examination, including their engagement letter. The auditors' fees are to be arranged with management and annually summarized for committee review. The committee's review should entail an understanding from the independent accountant of the factors considered by the accountant in determining the audit scope, including:
   - Industry and business risk characteristics of the company;
   - External reporting requirements;
   - Materiality of the various segments of the company's consolidated and nonconsolidated activities;
   - Quality of internal accounting controls;
   - Extent of involvement of internal audit in the audit examination;
   - Other areas to be covered during the audit engagement.
5. Review the extent of nonaudit services provided by the independent accountants in relation to the objectivity needed in the audit.
6. Review with management and the independent accountants, upon completion of their audit, financial results for the year prior to their release to the public. This review is to encompass:
   - The company's annual report to shareholders for Form 10-K, including the financial statements, and financial statement and supplemental disclosures required by generally accepted accounting principles and the Securities and Exchange Commission;
   - Significant transactions not a normal part of the company's operations;
   - Changes, if any, during the year in the company's accounting principles or their application;
   - Significant adjustments proposed by the independent accountants.
7. Evaluate the cooperation received by the independent accountants during their audit examination, including their access to all requested records, data, and information. Also, elicit the comments of management regarding the responsiveness of the independent accountants to the company's needs. Inquire of the independent accountants whether there have been any disagreements with management which if not satisfactorily resolved would have caused them to issue a nonstandard report on the company's financial statements.
8. Discuss with the independent accountants the quality of the company's financial and accounting personnel, and any relevant recommendations which the independent accountants may have (including those in their "letter of comments and recommendations"). Topics to be considered during this discussion include improving internal financial controls, the selection of accounting principles, and management reporting systems. Review written responses of management to the "letter of comments and recommendations" from the independent accountants.
9. Discuss with company management the scope and quality of internal accounting and financial reporting controls in effect.
10. Apprise the board of directors, through minutes and special presentations as necessary, of significant developments in the course of performing the above duties.
11. Recommend to the board of directors any appropriate extensions or changes in the duties of the committee.
12. Recommend to the board of directors the retention or nonretention of the independent accountants, and provide a written summary of the basis for the recommendations.

A Food Company

The Audit Committee performs the function of monitoring on behalf of the board of directors the adequacy and effectiveness of the internal and external audit functions, control systems, financial accounting and reporting, and adherence to applicable legal, ethical and regulatory requirements. The committee's specific responsibilities include the following:

A. Independent Public Accountants:
   1. Recommend to the board the selection of the independent public accountants for the annual audit, giving consideration to independence, effectiveness and cost.
   2. Approve, in advance, the planned scope of the examination of the company's financial statements by the independent accountants.
   3. Approve, in advance, non-recurring services to be performed by the independent accountants.
   4. Meet privately at least annually with the independent accountants to review the adequacy of the company's internal controls, accounting policies and procedures and the internal audit function.

B. Internal Audit, Accounting, and Reporting:
   1. Review with management the adequacy of the company's systems of internal control to provide reasonable assurance that assets are safeguarded, prescribed policies and procedures are followed and transactions are properly recorded and reported.

2. Review and approve major changes in the duties and responsibilities of the corporate controller and the company's accounting policies, principles or practices.
3. Review recommendations of the independent accountants resulting from the audit to be sure that appropriate actions are taken by management.
4. Review the activities, plans, responsibilities and capabilities of the internal audit function.
5. Review with management and/or the independent accountants any matter of disagreement between management and the independent accountants.
6. Review with management the status of tax returns and tax audits.
7. Review officers' reimbursed expenses and perquisites with regard to their proper reporting and accounting.

C. Legal and Ethical Conduct, and Conflicts of Interest:

1. Review the company's policies and practices related to compliance with the law, ethical conduct and conflicts of interest, to be satisfied that such policies are adequate and are adhered to by the company.
2. Review current or pending litigation involving the company which may have a material financial impact on the company or relate to matters entrusted to the committee.

D. Security:

Review the company's policies and practices related to security of assets, information and key personnel to be satisfied that such policies are adequate and are adhered to by the company.

E. Special Investigations:

Direct any special investigations concerning matters relating to the company's financial statements, internal controls, compliance with the law or business ethics.

The committee shall be available at all times to receive suggestions, questions or recommendations from the independent public accountants, the general auditor, the controller or general counsel.

The committee will report to the full board in writing at least annually on the activities and findings of the committee.

A Petroleum Company

RESOLVED, That the objectives of the Audit Committee are:

1. to assist the board of directors in fulfilling its fiduciary responsibilities relating to the company's financial reporting standards and practices,
2. to determine the adequacy of and promote the company's continued emphasis on internal financial controls,
3. to maintain open, continuing and direct communication between the board of directors and both the company's independent public accountants and its internal auditors, and
4. to instigate any special investigations of conflicts of interest, and compliance with federal, state and local laws and regulations, including the Foreign Corrupt Practices Act, as may be warranted, and be it further

RESOLVED, That the primary operating policies of the Audit Committee are:

1. The Audit Committee shall be composed of three or more outside members of the board of directors. Members of the Audit Committee shall be appointed and removed and the chairman of the committee shall be elected by action of the non-employee members of the board of directors.
2. The Audit Committee shall hold such meetings as deemed necessary but shall endeavor to meet a minimum of three times per calendar year. Minutes of all committee meetings shall be taken and approved at subsequent meetings.
3. Upon the request of the independent public accountants or the company's general auditor, the chairman of the Audit Committee shall convene a meeting of the committee to consider any matters such auditors believe should be brought to the attention of the committee, directors or stockholders.
4. The Audit Committee has the authority to direct and supervise an investigation into any matter, including the authority to retain outside counsel or other professional services, and be it further

RESOLVED, That the functions of the Audit Committee shall be to:

1. Recommend to the board of directors the selection, retention and, when necessary, the termination and replacement of the principal (and/or other) firm (or firms) of independent public accountants (i.e., external auditors) to examine the consolidated financial statements of the company.
2. Review with the principal external auditors their audit plans and scope for the coming year and any non-audit services performed or planned. The committee shall review the compensation paid the external auditors for all audit and other services performed.
3. Review with the external auditors the audit report and their comments arising from the audit.
4. Review with the company's general auditor the internal audit organization and the internal audit goals and plans and discuss the findings and recommendations resulting from internal audits.
5. Review with the company's controller the responses taken to the audit findings and the adequacy of the systems of internal financial control.
6. Review the company's proxy statement and the annual report to stockholders and to the Securities and Exchange Commission.
7. Review with the company's financial management on a periodic basis any changes in accounting principles

significantly affecting the company.

8. Review with the company's financial management any unusual, non-operating and/or non-recurring items and the general quality of earnings reported by the company.

A Metals Company

The Audit Committee shall be responsible for reviewing the adequacy of corporate financial reporting, accounting systems and controls, security of data processing systems and records, and the internal and external auditing functions. The committee shall also maintain a direct and separate line of communication between itself and the internal and external auditors. The committee shall consist of at least four members all of whom shall be nonmanagement directors. One committee member shall be selected as chairman by the Nominating Committee and approved by the board of directors. None of the committee members shall serve on the committee for more than four consecutive years; provided, however, that a committee member may be reappointed to the Audit Committee after a lapse of membership on the committee for a period of at least one year. The terms of the committee members shall be established on a stagger basis so that at least one new member is appointed to the committee at each annual meeting of the board. The committee shall meet at least three times annually and additional meetings shall be held upon the call of the committee chairman. The controller, manager-internal audit and a representative from the external auditor shall attend each committee meeting. The general counsel and secretary or alternate shall attend meetings of the Audit Commitment for the purpose of providing counsel and preparing minutes of the meetings and performing other duties as required. Non-committee members may be excused from attendance at any meeting or portion of any meeting of the Audit Committee by the committee chairman.

In order to accomplish its purpose, the committee shall do the following:

1. a. Recommend to the board of directors each year the particular firm to be employed as external auditor to examine and report upon the financial statements of the company (hereinafter referred to as "external auditor").
   b. Approve the appointment of other external auditors employed for specific audit purposes other than that listed in 1.a.
2. Meet with the external auditor prior to the commencement of the annual audit examination each year and discuss:
   a. The adequacy of the scope of the audit.
   b. The adequacy of the company's accounting principles, policies, security and practices, and any contemplated material changes thereto.
   c. New developments in accounting principles or reporting practices which may materially affect the company.
   d. The audit fees—but not to set same.
3. Review the scope of the internal audit program to be performed each year.
4. Review and approve non-audit activities to be performed by the external auditor prior to the commencement of such activities. Also consider what effect, if any, said activities will have on the external auditor's independence.
5. Review all internal and external audit reports and any written management responses thereto.
6. Review annually (a) the expense reports of the chairman of the board and chief executive officer, (b) a summary report of expenses incurred by other executive officers and (c) the use ~~of~~ the company aircraft by executive officers.
7. Periodically review the following:
   a. Conflict of interest statements.
   b. Litigation in which the company is involved or may become involved.
   c. Questionable uses of corporate assets.
8. Prior to submitting the annual consolidated financial statements to the board of directors for final approval, review and discuss with the external auditor and company financial management:
   a. The results of the completed annual audit.
   b. The external auditor's overall evaluation of the annual financial statements.
   c. Financial management's overall evaluation of the annual financial statements.
9. Discuss with external and internal auditors annually:
   a. The adequacy of internal accounting controls and procedures.
   b. Suggestions for improvements in accounting, data processing, financial and operating controls as expressed in the external auditor's annual letter to management.
   c. The extent to which any previously identified control and procedural weaknesses have not been corrected and the reasons why.
   d. The adequacy of the company's annual and interim reporting practices and external auditor's views concerning the quality of reports to shareholders.
10. Review with the external auditor at least annually their evaluation of the technical competence and adequacy of the company's financial department staff.
11. Examine and consider such other matters in relation to the internal and external audits of the company's accounts and in relation to corporate accounting and reporting matters as the committee may, in its own discretion, determine to be desirable.
12. Regular committee meetings shall be held as follows:
    a. In April, prior to the beginning of the annual audit.
    b. In August, after the completion of the annual audit and the preparation of the annual consolidated financial statements.
    c. In October, after completion of the external auditor's

management letter and the company's response thereto.

13. Perform such other functions which from time to time may be assigned to it by the board of directors.

An Energy Company

The Audit Committee ("the committee"), under delegation of authority by the board of directors, shall (a) assist the board of directors in the discharge of its fiduciary responsibilities relating to the company's accounting principles, reporting practices and internal controls; (b) maintain a direct line of communication with the company's internal and external auditors, and assess their performance and (c) recommend the appointment of independent auditors for consideration by the shareholders of the company.

Membership

The committee shall be comprised of a minimum of three unaffiliated directors. The board of directors shall, at its annual organizational meeting, appoint the chairman and, when feasible, a minimum of one but not more than two new members to the committee. Membership on the committee should be rotated periodically, the objectives of which shall be twofold:

1. To provide new perspectives for deliberation by the committee; and
2. To aid in the alleviation of the committee's copious work demands.

Duties and Responsibilities

A. Recommend to the board of directors a firm of independent auditors to be engaged by the company.
B. Review and approve the fee, scope and timing of the audit and other related services rendered by the independent auditor.
C. Review with the independent auditors, upon completion of their audit:
   1. contents of their report;
   2. adequacy of the company's financial and auditing personnel;
   3. cooperation received during the audit;
   4. company resources used;
   5. significant transactions outside of normal company business;
   6. changes in accounting principles and practices; and
   7. significant proposed adjustments and recommendations for improving internal accounting controls, principles or management systems.
D. Review the non-audit services provided by the independent auditor.
E. Approve the selection and/or discharge of the general auditor and appraise his/her performance annually.
F. Review and approve the internal audit plan.
G. Review the highlights of significant internal audit findings and recommendations, and management's response thereto.
H. Review the appropriateness and soundness of the company's policies and practices with respect to internal auditing, accounting and financial controls.
I. Review the company's quarterly earnings, including the impact of unusual items and changes in accounting principles and estimates.
J. Review and approve the financial sections of the annual report to shareholders, the SEC Form 10-K and appropriate proxy material.
K. Review, appraise and report to the board of directors existing difficulties and problems with regulatory agencies which are likely to have a significant financial impact.
L. Review compliance under the company's business conduct policies. Periodically review these policies and recommend to the board of directors changes which the committee may deem appropriate.
M. Review the application of policies and procedures used to handle various matters for which conflicts of interest could arise in connection with the company's master limited partnership.
N. Periodically review the company's financial and auditing staff, accounting and auditing procedures and the extent to which recommendations made by the internal audit staff or by the independent auditors have been implemented.
O. Receive and review reports from the general counsel relating to legal compliance.

Lines of Communication

The general auditor and the independent auditor shall have a direct line of communication to the committee and may bypass management if deemed necessary. The general counsel shall report directly to the committee with regard to legal compliance. The committee may contact directly any employee in the company as it deems necessary, and any employee may bring before the committee matters involving questionable, illegal or improper practices or transactions.

The committee shall report to the board of directors on the fulfillment of its duties under the mandate delegated to it by the board of directors.

Meetings

The committee shall meet at least once each quarter and at such other times as may be requested by its chairman.

Required meetings with the independent auditor are as follows:

March	Review the audit results, the auditor's opinion, the auditor's perception of the adequacy of the financial staff, and other observations.
September	Review the actual fees for the prior year and the scope and estimated fees for the coming year.

November Review significant management letter items.

Meeting Attendance

The following management representatives should attend all meetings except executive sessions and private sessions with the independent auditors:

Executive Vice President (Principal Financial Officer)
Senior Vice President, General Counsel
Corporate Comptroller
General Auditor

Other management representatives shall attend as necessary.

Supporting Material and Agendas

The committee secretary (the general auditor) and the executive vice president shall prepare a tentative agenda and circulate it among the Audit Committee members. The chairman of the committee has the final say regarding the agenda items.

The agenda and all materials to be reviewed at the meetings should be in the hands of the Committee members at least by the weekend preceding the meeting day.

The committee secretary should coordinate all mailings to the committee members, to the extent practicable.

A Savings and Loan Association

I. *Statement of Policy*

The board of directors has oversight responsibilities to ensure the association maintains an adequate system of internal control and financial reporting, and is in compliance with all applicable laws and regulations. Through this charter, the board delegates certain duties and responsibilities to the Audit Committee (Committee) to assist it in fulfulling these responsibilities.

The primary responsbilities of the committee are to 1) oversee the association's system of internal accounting control and the financial reporting process, 2) review the internal audit function, 3) select the association's independent auditors, and 4) review all audit reports. These and other areas of responsibility are described later in more detail.

To discharge its oversight responsibilities effectively, the committee will maintain open lines of communication with the chief financial officer, chief internal auditor, and with the association's independent auditors.

The board recognizes that an informed and vigilant audit committee represents an effective influence for ensuring adequate internal controls and fair and complete financial reporting. The members of the committee are expected to discharge their duties with the same good faith, diligence, care and skill expected of the other directors of the association.

II. *Organization and General*

A. The committee shall be composed of not less than three and no more than five non-management directors.

B. The committee shall have a chairman, appointed by the board of directors. The chairman shall conduct and preside at each meeting of the committee. The committee shall appoint a secretary who shall keep a record of the committee's proceedings.

C. The committee shall meet at least once each quarter to review the financial statements, the activities and reports of the internal auditor and the independent auditor, and other matters requiring consideration by the committee. The committee chairman may call other meetings during the year as necessary.

D. The committee shall have the power to adopt its own operating rules and procedures and to call upon assistance from officers nd employees of the Association.

E. The committee shall report its activities to the full board following each meeting of the committee to keep the board informed of all committee activities and findings on a current basis.

III. *Duties and Responsibilities*

A. *Oversight of Internal Accounting Controls*

The committee shall be responsible for overseeing the association's internal accounting controls. These controls should be designed to assure that assets are safeguarded, transactions are authorized, and that transactions are properly recorded. Senior management, the chief internal auditor, or the independent auditors may be called on to discuss the accounting control system and changes thereto as may be needed.

B. *Review of Internal Audit*

1. The committee shall review the annual internal audit plan with the chief internal auditor. The review shall focus on the scope and effectiveness of internal audit activities and the department's capacity to fulfill its objectives. The committee shall inquire as to the extent the planned audit scope can be relied upon to detect fraud or weaknesses in internal controls.
2. The committee shall review all internal audit reports, including management replies, and the status of any corrective actions taken by management.
3. The committee shall meet privately with the chief internal auditor at each meeting, and with the independent auditor at meetings, the independent auditor presents the audit plan or presents audit findings.
4. The committee shall have final authority over the appointment and dismissal of the chief internal auditor.

C. *Independent Auditors*

1. Management shall recommend to the committee the selection, retention, or change in the association's independent auditor. The committee shall, after due consideration of management's recommendations, make the recommendation to the board concerning the elec-

tion, retention or change of the independent auditor.

2. The independence of the independent auditor shall be reviewed periodically with management and with the independent auditor. To assist the committee, management shall inform the committee of all plans to engage the independent auditor to perform management advisory services or other non-audit services for the Association.
3. The committee shall meet with the independent auditor prior to the audit examination to discuss the audit plan, including the scope, staffing and timing of the audit, extent of coordination with internal audit, and discussion of prior audit problems and consideration of other problems that may be expected during the upcoming audit.
4. The committee shall meet with the independent auditors subsequent to each audit to review any significant auditing or accounting problems encountered during the audit, and the level of support provided by the association's accounting and internal audit staffs. The independent auditor will also review with the committee any audit findings concerning the adequacy of system of internal controls and compliance therewith, including the responses provided by management of any such findings.

D. *Oversight of Financial Reporting*

1. The annual audited financial statements of the association and each of the quarterly unaudited financial statements shall be reviewed by the committee. The purpose of the review shall be to evaluate the financial reporting process to ensure that the financial statements fairly present the financial position and results of operations of the association in accordance with generally accepted accounting principles, consistently applied. The committee shall inquire as to the following:
   - Significant variations in financial information between reporting periods.
   - Changes in accounting standards or rules promulgated by the Financial Accounting Standards Board or Securities and Exchange Commission that have an impact on the financial statements.
   - Estimates made by management having a material impact on the financial statements.

E. *Other*

2. The committee shall review annually management's plan for determining compliance with the Corporate Code of Conduct.
3. The committee shall help assure that the association is operating in accordance with applicable laws, regulatory policies and guidelines as they relate to the functions and responsibilities of the audit committee.
4. Where appropriate and indispensable to protect the assets of the association and the interests of the stockholders, the committee shall have the authority to engage adequate resources and have standing authority to initiate investigations, including the authority to retain counsel or other outside experts.
5. Periodically review fees paid for external audit services.

A Savings Bank

Purpose: This document is to provide direction and guidance to govern the activities of the Audit Committee formed by resolution of the board of directors.

Scope: It is the intent of the board of directors to furnish hereby a reference source concerning the basis of establishing an Audit Committee and specifying the authority, composition, meeting requirements, primary functions, and procedures for recording and reporting the activities of the committee.

Basis: Federal Home Loan Bank Board Memorandum – R 44, dated May 22, 1978, subject: "Audit Committees of Boards of Directors."

Authority: The intent of the board of directors is to have the Audit Committee serve to monitor selected internal bank affairs for the board. The committee is authorized to seek facts, form opinions, report findings to the board, and, if called for, make recommendations to the board for consideration. The Audit Committee is not empowered to take action, make decisions, or otherwise act for the board of directors in any way affecting the operations of the bank. The Audit Committee reports to the board and ultimately to the stockholders.

Composition: The Audit Committee shall be comprised of members of the board of directors appointed by resolution of the board. The Audit Committee shall have at least three members. All directors shall be eligible to serve on the Audit Committee except those directors who are employed by the association in a management position.

Meetings: There is no intent to limit or control the number, location, or nature of the meetings held by the audit committee. However, the following guidelines are established:

a. The Audit Committee shall meet at least once each quarter.
b. Normally, meetings should be held at the offices of the bank.
c. The Audit Committee may have available at meetings any operating personnel deemed necessary by the committee. However, to provide support information, the chairman of the board, president, vice president of lending, marketing director, and the chief financial officer/controller will be available to the committee upon request.
d. The Audit Committee, upon request, may have the independent auditors in attendance at any meeting.
e. The chairman of the board of directors may be present at any meeting.
f. By request to the chairman of the board prior to meetings, the committee can have available any documents or reports for reference or examination.

Primary Functions: The Audit Committee is to assist the board of directors by providing detailed examination and monitoring of activities relating to the independent auditor, internal controls, security, budgeting and financial reporting. To carry out these functions, the committee activities are to include, but are not limited to, the following.

The committee assumes the board's responsibility for financial and internal control. This is not to imply that the full board is absolved of financial responsibility, but only that the Audit Committee bears the primary responsibility for monitoring these areas and relating findings to the full board.

With respect to the Audit Committee, the Audit Committee will:

a. Review the results of audits and activities of the internal auditor.
b. In consultation with senior management, recommend the selection of the bank's independent auditors to the board.
c. Review the scope of the yearly exam with the independent auditors prior to the commencement of the audit. Areas that should be discussed are:
   1. Time frame for the audit.
   2. Special risk areas that will require special attention.
   3. Independence of the auditors.
   4. Fees for the audit.
   5. Current accounting principles.
d. Review the complete audit report with the auditors after the audit. Areas that should be discussed are:
   1. Time and/or fee variances.
   2. Management letter recommendations.
   3. Whether or not management cooperated fully by providing all information and explanations that were requested.
   4. Financial statement analysis.
   5. Status of internal control.
e. Report to the board the result of the committee review, with particular emphasis on any items which are judged to warrant special consideration by the board.
f. With respect to the annual Federal Home Loan Bank examination, the Audit Committee will:
   1. Review the final report from the FHLB.
   2. Review management's response to the final report.
   3. Discuss with management any plans (if necessary) to rectify problems noted in the report.
   4. Report to the bank.
g. Review the nature and impact of any proposed changes in accounting policies or principles, with particular emphasis on the effect of such proposals on financial statements of the bank.
h. Review the proposed annual operating budget with the managing officer and other appropriate operating personnel. Inform the board of the result of the committee's review when the annual budget is presented to the board for action.
i. Each quarter, review with management the budget variance analysis for the quarter and year-to-date. Report to the board any significant information deemed appropriate for board consideration.
j. With assistance as needed from the internal auditor, observe and monitor selected internal control measures as desired. Bring to the attention of the managing officer any item judged in need of improvement.
k. Monitor the adequacy of the security provisions and procedures of the bank.
l. Upon request by the managing officer, provide detailed interface knowledge to the board on a project, proposal or report deemed appropriate by the managing officer.
m. Review with senior management the annual stockholders report and each quarterly report prior to publication.
n. Review with management the bank's insurance coverage on a semi-annual basis.
o. Review with management the data center's independent third party review annually.
p. Perform other projects that may be requested by the full board, the chairman of the board, or the president.

Records and Reports: The Audit Committee will be required to maintain separate minutes. The intent of the board of directors is to have the Audit Committee serve to monitor selected internal bank affairs for the board. The committee is authorized to seek facts, form opinions, report findings to the board, and, if called for, make recommendations to the board for consideration. The Audit Committee is not empowered to take action, make decisions, or otherwise act for the board of directors in any way affecting the operation of the bank.

A Bank Holding Company

Preface

The principal responsibilities of the Auditing Committee and the Trust Examining Committee, hereinafter referred to as the Committee, are to satisfy itself on behalf of the board of directors as to the soundness of the asset position and the accuracy and integrity of the financial reporting structure of the committee and its subsidiaries, and to determine that operations are conducted on an ethical basis and in compliance with all applicable laws, rules and regulations.

It should be noted that the committee is not primarily responsible for the quality of credits or investments nor expected to correct any deficiencies in operations or financial reporting. This responsibility rests with the management of the corporation, who must take all necessary action to maintain the integrity of assets, operate the business consistent with sound and proper practices, and take corrective action when necessary.

The existence of the committee and the delegation to it of certain powers and duties by the board of directors does

not relieve any individual member of the board of directors from his responsibility to satisfy himself that the affairs of the corporation are being properly conducted.

The minutes of all meetings of the committee together with all supporting schedules and data received and reviewed by the committee are available for examination by any directors upon request to the secretary of the committee. Subject to this understanding, the manner in which the committee will discharge its responsibilities is set forth in the following paragraphs.

Independent Auditors

The committee will review and approve where appropriate the following reports of the independent auditors:

(1) Reports on the limited review of unaudited quarterly financial statements;

(2) A written summary submitted in advance of each annual audit outlining the scope of such audit and the audit plan;

(3) The results of the annual audit, including all criticisms and suggestions.

The committee will recommend to the board of directors each year the retention or otherwise of the independent auditors, and will review their fees for services.

In those instances where it is necessary to retain independent public accountants other than the principal firm of public accountants employed by the corporation to perform auditing services (ordinarily overseas) the determination of the scope of such audits, the fees to be paid, and the administrative relationship to be maintained with such public accountants shall be the responsibility of the general auditor, who shall keep the committee fully informed as to the findings and recommendations of such public accountants. Selection and retention of such public accountants for the conducting of such audits shall be the joint responsibility of the general auditor and the executive vice president-world banking, as approved by the committee.

Internal Auditing and Credit Examining

The committee will review on a quarterly basis the internal reports of the chief credit examiner and of the general auditor with the understanding that any unusual happenings in areas under their respective jurisdictions will be brought to the immediate attention of the committee. All such internal reports will be transmitted to the committee with an appropriate covering letter of transmittal summarizing the activities reviewed and noting any adverse trends, deficiencies, or evidence of deterioration in either the accounting and control structures of the corporation, or in the policies and practices governing the extension of credit.

The committee will concur in the selection, retention, and compensation of the chief credit examiner and the general auditor, the nature of the work to be performed, and the size and adequacy of their respective staffs.

Outside Examining Agencies

Members of the committee will be furnished immediately upon receipt with a copy of all examinations/audit reports from the Comptroller of the Currency, Federal Reserve Bank, Federal Deposit Insurance Corporation, state banking departments, and any other regulatory authorities with jurisdiction in the area of the committee's responsibilities. See exception below.

The committee will review all such reports promptly and will be furnished with copies of management acknowledgment and responses on a timely basis where such is required. The monitoring of such responses is the responsibility of the general auditor, who shall report at each meeting of the committee as to the current status of any reports requiring response where such response has not been made.

Major reports normally reviewed in this category include the following:

Area Examined	*Examining Agency*
Principal Subsidiary Bank	Comptroller of the Currency
International (World Banking)	"
Electronic Data Processing	"
Consumer Credit	"
Foreign Offices	"
Trust Division	"
Parent Corporation	Federal Reserve Bank
International Bank	"

Copies of examination/audit reports of agencies other than those detailed above need not be sent to members of the committee if in the judgment of the general auditor they contain no material adverse criticisms or significant recommendations. In such instances the general auditor will make suitable reference to the receipt of such examinations/audit reports in his next quarterly written report to the committee.

Other Reports to be Furnished to the Committee:

Within 90 days of the close of each fiscal year, or within 90 days of June 30 in each year, the committee will be furnished with a detailed report of the following:

(1) A schedule of all loans and commitments to directors and companies affiliated with directors showing the amount, rate, repayment schedule, and collateral applicable to such loans and commitments as of the end of each fiscal year (6/30).

(2) A list of all loans/commitments of the bank of $5 million or more and of the mortgage company of $2 million or more (6/30).

(3) A schedule of all loans or securities sold with liability to repurchase all or any part, or with recourse in any way to the bank, the mortgage company, and the credit company (12/31).

(4) A schedule of all loans to officers of other banks in excess of $100,000 showing the amount, rate, repayment schedule, and collateral applicable to such loans.
(5) A schedule of all loans other than those reported in (4) above in excess of $100,000 secured by the stock of other banks showing the amount, rate, repayment schedule, and collateral applicable to such loans (6/30).
(6) Copies of the statement of indebtedness given to the national bank examiners by each executive officer of the bank.
(7) A schedule of all travel and expense accounts of executive officers and directors, and of any other officers where the annual amount exceeded $10,000, listed as to name, title, and amount.
(8) A detailed schedule showing the composition of "Other Assets" and "Other Liabilities" (12/31).
(9) A detailed schedule of letters of credit issued for any amount in excess of $100,000 for any purpose other than the short term financing of the self-liquidating movement of tangibles (6/30).

All such schedules will be furnished to the committee with a covering letter of transmittal from an appropriate senior office of the bank, parent corporation, or other subsidiary as may be applicable.

Other Areas Reviewed:

The committee will review policies and procedures applicable to the following areas:
(1) Integrity of electronic data processing systems and facilities
(2) Foreign exchange operations and controls
(3) Conduct of overseas operations
(4) Wire transfer

Compliance with Policies:

The Comptroller of the Currency requires written policies to be established by the Bank and approved by the board of directors covering the following areas:
(1) International loan portfolio management
(2) Foreign exchange
(3) Due from foreign banks
(4) Loan policies and procedures
(5) Reserve for possible loan losses
(6) Investment portfolio management
(7) Bank dealer activities
(8) Liquidity, asset and liability management

Any significant deviation from, violation or exception to such established policies coming to the attention of any executive officer, the general auditor, or the chief credit examiner shall be promptly reported to the committee by letter addressed to the secretary.

Pending Litigation

Within 90 days of the close of each fiscal year, the committee will be furnished with a letter from the executive vice president and general counsel summarizing the status of any material pending or threatened litigation, claims and assessments. This letter shall include as an attachment a similar letter addresses by the chief outside counsel of the bank to the independent public accountants, and will elaborate and supplement such letter to the extent necessary.

Compliance with Law

Within 90 days of the close of each fiscal year the executive vice president and general counsel of the bank, the secretary of the bank, and the secretary of the parent corporation will each furnish a letter addressed to the committee stating that to the best of their knowledge and belief the bank, the corporation, and other major subsidiaries are in compliance with all applicable laws, rules, and regulations.

Standards of Business Conduct

The committee will review annually the written policies of the corporation and its subsidiaries applicable to conflict of interest and to the ethical and legal conduct of business as to their adequacy and proper dissemination.

Authorizations

The committee is authorized and empowered by and on behalf of the board of directors to acknowledge by the signature of its members the receipt and review of all reports from supervisory authorities where such acknowledgement is permitted by law.

Meetings

The committee will meet not less frequently than quarterly and as frequently as necessary to perform its duties.

Implementation of Recommendations and Instructions

Copies of minutes of all meetings will be furnished by the secretary to the chairman of the parent corporation and to the president of the bank. It will be their responsibility to initiate any action necessary to be responsive to recommendations and to comply with instructions which may be reflected in said minutes.

Reports to the Board of Directors

(1) In order to insure that the board of directors is fully informed on a timely basis concerning the activities of the committee, the chairman of the committee will report to the board at the next regular board meeting following any meeting of the committee, and a copy of the minutes of such meeting will be included in the book of exhibits regularly furnished to the board.
(2) A copy of the complete report of all examinations made by the Officer of the Comptroller of the Currency and the Federal Reserve Bank will be mailed to each member of the committee at the time it is received by the bank and it will be reviewed by the committee at its next meeting.

(3) A copy of the covering letter of such examinations, directed to the board of directors, will be mailed to each director at the same time as the full report is mailed to members of the committee and directors will be informed that a copy of the full report is available for their review in the office of the secretary of the committee.

(4) At the board meeting following receipt of the report, the chairman of the committee will review the letter and any other significant comments in the report which were not included in the covering letter. Management will likewise comment on the anticipated course of action in the event there are any significant criticized items.

A Bank Holding Company

RESOLVED that the Audit Committee of the Board of Directors perform the following functions:

(1) Receive periodic reports from management, the independent auditors, or the internal auditors, assessing the impact of material and significant regulatory changes and accounting developments;

(2) Review the corporation's consolidated annual financial statements with the independent auditors and management;

(3) Review, in consultation with the independent auditors, the results of their audit of the corporation, the report of such audit, any related management letter, and management's response to recommendations made by the independent auditors in connection with the audit, and appraise the effectiveness of such external audit;

(4) Receive and review reports and management letters of independent accountants on all major subsidiaries;

(5) Review and approve the independent auditors' fees, and the independence of such auditors, and determine that not restrictions are being placed by management on the scope of their examination;

(6) Review and approve the appointment or reappointment, as the case may be, of the firm recommended by management to be employed by the corporation and its major subsidiaries as their independent auditors;

(7) Receive and review verbal and/or written reports from the Audit and/or Examining Committees of all major subsidiaries;

(8) Review reports of examinations by agencies having regulatory authority with respect to the corporation and/or its major subsidiaries, and evaluate management's responses thereto;

(9) Review litigation involving the corporation, including major litigation involving its subsidiaries;

(10) Prepare reports as necessary, but in any event at least annually, summarizing the work done by the committee in performing the functions set forth above.

An Electric Utility Company

Purpose

The primary purpose of the Audit Committee shall be to establish and maintain continuing communications between the board and the company's independent auditors, internal auditors and members of financial management. The committee shall have unrestricted access to, and shall be authorized to communicate directly with, each of these groups. The executive vice president and chief financial officer, the treasurer, the comptroller and the manager, internal auditing shall serve as the primary liaisons between the Audit Committee and the company.

Functions

1. The Audit Committee shall be responsible for reviewing the proposed scope of the annual year-end audit with the independent auditors before they begin their examination to determine that management has imposed no restrictions and that problem areas will get special attention.
2. The Audit Committee shall review the results of the annual year-end audit with the independent auditors to determine whether the auditors are satisfied with the financial statements and related disclosures. At the same time, the committee shall obtain sufficient information about the examination to enable it to respond to inquiries by the full board. The board shall rely upon the Audit Committee to recommend whether the financial statements should be approved for inclusion in the annual report.
3. The Audit Committee shall consider the nature of the auditors' report letter and, in situations where other than an unqualified report is contemplated, obtain a complete explanation. The committee shall ascertain that the auditors were not restricted in performing their examination. The Audit Committee shall receive explanations for significant adjustments proposed but not recorded and adjustments recorded but not previously contemplated. The Audit Committee shall determine whether there have been any disagreements that have not been resolved to the satisfaction of either management or the independent auditors. The committee shall be responsible for obtaining all relevant information about the audit and communicating it in a meaningful manner to the full board.
4. The Audit Committee shall familiarize itself with the company's internal controls and ascertain that the independent auditors' recommendations to management have been adequately considered and properly implemented.
5. The Audit Committee shall review contemplated changes in accounting policies and accounting, reporting and auditing proposals promulgated by regulatory and professional bodies. It shall also ascertain the

nature and adequacy of company policies on political contributions, conflicts of interest and compliance with federal, state or local laws and regulations.

6. The Audit Committee shall be responsible for nominating the independent auditors and for recommending their termination. In considering nominations for independent auditors, the committee shall be sensitive to management's special needs, if any, and prior experience with auditing firms.
7. The Audit Committee shall review the scope of non-audit services performed or to be performed by the independent public accountants, as well as the related fees, and consider the possible effect that the non-audit services could have on the independence of the accountants.
8. The Audit Committee shall receive its authority from and report directly to the full board and shall operate with a minimum of restraints.
9. The Audit Committee's role shall be to review and advise but not to make decisions. The committee shall demonstrate a constructive, supportive and advisory approach.
10. The Audit Committee shall be a standing committee and it shall consist of three outside (i.e., non-employee or independent) directors.
11. The chairman of the Audit Committee shall be responsible for developing an agenda of the meeting sufficiently in advance of the meeting to permit all parties to prepare for the matters under consideration. The agenda shall be developed after consultation with the company's independent auditors, internal auditors and members of financial management. The manager, internal auditing shall provide necessary support to the chairman of the audit committee for compiling, typing and distributing the agenda and other items to the members and other attendees. When possible, reports on agenda topics shall be distributed well before the meetings to allow committee members to prepare themselves better and participate on a more informed basis.
12. Normally, the Audit Committee shall meet jointly with the company's independent auditors, internal auditors and members of financial management. Other members of management shall attend meetings of the Audit Committee only when requested by the chairman of the Audit Committee. The Audit Committee may meet with any of these groups individually where they believe the discussion might be inhibited if any members of the other groups were present or for any other reason deemed appropriate.
13. Minutes of the Audit Committee meetings shall be prepared in draft form by the manager, internal auditing for review and approval of the chairman of the Audit Committee. Approved minutes of the meetings of the Audit Committee shall be distributed to all members of the Audit Committee within fifteen days after the subject meeting.
14. As requested, the company shall provide staff support for the Audit Committee. Requests for such staff support shall be made to the manager, internal auditing.

Activities

The Audit Committee shall hold a minimum of three meetings each year. One meeting shall be held in February at the completion of the annual year-end audit and before the annual report is released. Another regular meeting shall be scheduled in May to discuss internal audit activities and other matters. Additional meetings may be scheduled as required at any time during the year.

A Retailing Company

Function

To assist the board of directors in fulfilling its fiduciary responsibility relating to the accounting, financial, and reporting policies and practices of the corporation and its monitoring of employee benefit plans, and to ensure that the corporation's standards of business conduct and ethics are being observed. These functions will be accomplished by:

- Encouraging management to install and maintain comprehensive systems of internal control that are designed to: aid in the prevention or detection of deviations from the corporation's policies; provide reasonable assurance that assets are safeguarded from unauthorized use or disposition; ensure that the resulting books or records are reliable for the preparation of financial statements or other uses;
- Reviewing new (or changes to existing) financial and accounting policies and practices;
- Monitoring reported results of operations and financial position;
- Ensuring that vigorous, objective audit programs are conducted in the preceding areas by both the independent external auditors and the internal auditors.

Duties

1. *Accounting and Reporting*
   Review and authorize proposals by management for new (or changes to existing) policies and practices. Review annual publicly reported earnings and major underlying issues such as reserves, LIFO adjustments, etc. Review the annual shareholders and 10-K reports. Meet privately with the corporate controller at least annually to solicit comments.
2. *Independent External Audit*
   Review management's annual recommendation for appointment of the independent external auditor and make recommendation to the board. Review and approve proposed audit scope for adequacy of coverage. Review and approve non-audit services performed by the independent external auditors for potential impact on their independence. Review results of the audit from a financial

point of view and solicit auditor concerns. Review the independent auditor's letter report relating to status of internal controls and other matters they deem appropriate. Obtain management's response and corrective action plan. Meet privately with the independent auditors at least annually to solicit comments. Review management's evaluation of the independent auditor's audit performance.

3. *Internal Audit*

   Review and approve the annual corporate-wide internal audit plan for adequacy of coverage and coordination with the independent external auditors. Review results of the internal audit effort on an annual basis or more frequently when warranted by specific audits. Meet privately with the corporate chief auditor at least annually to solicit comments.

4. *Employee Benefit Plans*

   Review and evaluate the annual reports of the Plan Investment Committee and Plan Administrative Committee. Review and evaluate management's recommended appointments to the Plan Committees and make recommendations to the board. Review and evaluate management's recommended appointments of plan actuary and trustees and make recommendations to the board. Review and evaluate Plan Committees' recommendations to the board of substantive plan changes and plan contributions.

5. *Other*

   Obtain and review an annual report from the corporate general counsel on litigation and other matters. Review and monitor the Conflicts of Interest program conducted by the corporate general counsel. Obtain an annual report on the tax and insurance status of the corporation. Review the results of the annual audit of officer and director expenses and perquisites conducted by the independent external auditors and internal auditors. Report to the full board of directors on all matters deemed of interest to them.

Related Conference Board Publications

	Report No.
Corporate Directors' Compensation, 1988 Edition	903
Board Committees in European Companies	886
Corporate Directorship Practices: The Compensation Committee	829
Corporate Directorship Practices: The Nominating Committee and the Director Selection Process	812
Corporate Directorship Practices: The Planning Committee	810
Corporate Directorship Practices: The Public Policy Committee	775
Corporate Directorship Practices: The Audit Committee	766
Corporate Directorship Practices: Role, Selection and Legal Status of the Board	646
Corporate Directorship Practices: Retirement Pay and Deferred Compensation for Outside Directors	RB115
Corporate Directorship Practices: Uncommon Committees of the Board	RB139
The Role of Outside Directors in Major Acquisitions or Sales	RB180
Liability Insurance for Directors	Perspectives, No. 1